

2014  
Vol. 25

# JOINT U.S.-KOREA ACADEMIC STUDIES

ASIA'S SLIPPERY SLOPE: TRIANGULAR  
TENSIONS, IDENTITY GAPS,  
CONFLICTING REGIONALISM, AND  
DIPLOMATIC IMPASSE TOWARD  
NORTH KOREA

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2014 | VOLUME 25

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# DIVERGENCE ON ECONOMIC REGIONALISM



## INTRODUCTION

For a time the endgame appeared to be under way in TPP (Trans-Pacific Partnership) negotiations and attention was shifting from the potential competition between TPP, RCEP (Regional Comprehensive Economic Partnership), and the CJK FTA (China-Japan-Korea Free Trade Agreement) to the implications of a TPP agreement for various countries. The United States continued to be the driving force, first prodding all parties to move ahead and then causing others to pause, as doubts were growing about whether Barack Obama would challenge his base in the Democratic Party prior to November's mid-term elections and press Congress for the critical TPA (trade promotion authority) that offers assurance to U.S. partners of an up-or-down vote on any agreement that is reached. Japan clearly has emerged as the second central force in these negotiations, whose bilateral talks with the United States are the principal venue for deciding what the outcome will be. In the background, South Korea looms as the foremost bridge to the countries not currently part of the 12-nation negotiating group, declaring its interest in considering whether to join the talks even as it weighs the implications for the CJK talks (or a narrower bilateral FTA with China) and for RCEP. Japan too is perched between talks to bolster its place in East Asian and Asia-Pacific regionalism. In the early spring of 2014 negotiations had slowed, but debate continued in all of these countries over the possible impact of a deal on TPP. President Barack Obama's late April visit to Japan was faulted for not reaching a deal, but it gave new momentum to the talks, increasing optimism that agreement is nearing.

The four chapters in Section III cover U.S., Japanese, Korean, and Chinese strategies about economic regionalism. Matthew Goodman's analysis centers on the U.S. policy goals in East Asia and how TPP fits into the multi-layered approach for achieving them. He showcases the concept of regional economic integration, pursued through a trans-Pacific orientation and a preference for comprehensive liberalization and high standard rules of the road. Dispelling myths about TPP, Goodman discusses its links to the overall Asian "rebalance" of the Obama administration. In spite of growing doubts in early 2014 about Congress, he concludes that the United States is likely to remain an active—even an impatient—participant in regional economic integration because this is essential for both domestic economic growth and international leadership. His analysis sets the terms for the discussions that follow on how thinking is advancing in Japan, in the midst of what is called Abenomics; South Korea, facing criticism in the U.S. Congress on implementation delays in the KORUS FTA that could lead to tough demands before it would be allowed into TPP negotiations; and China, uncertain about the geopolitical and economic impact.

Takashi Terada turns our attention to Japan's thinking on TPP, RCEP, and the CJK FTA. He argues that the U.S. push for TPP has energized all three of these negotiating efforts, influencing China to exert leadership and offering Japan a golden opportunity. Yet, he is careful to point to challenges in Japanese domestic politics, above all opposition to the liberalization of agricultural trade. Terada describes a process of "FTA dominoes," which can be best understood by assessing the economic power of FTA negotiating countries. Moving from a proliferation of bilateral FTAs to the intertwining of varied frameworks for multilateral FTAs, he concludes that states have entered a remarkable stage when economic integration can quickly advance. Terada pays special attention to the role played by South Korea's bilateral FTA with the United States and also the European Union in spurring Japan

to pursue TPP. Looking in detail at how Japan is proceeding in the talks with the United States, he evaluates developments in the RCEP and CJK FTA talks before recommending that the best outcome would be to conclude all of these talks with agreements to eliminate tariffs on some, but not all, “sanctuary” Japanese products.

If the emphasis for the United States is wide-ranging and high standards regionalism and for Japan is multiple regional frameworks with some variation in standards, the objective for South Korea, as discussed by Jin Kyo Suh, is balancing the United States and China in the process of achieving economic regionalism. Suh sees the balance between TPP and RCEP as having tilted with Japan’s avid pursuit of TPP. Concerned about then becoming marginalized, ASEAN has stepped up its efforts to conclude RCEP, and China has forged ahead in its own pursuit of RCEP as well as the CJK FTA. In these circumstances, Suh analyzes Korea’s views on all three frameworks. He concludes that it has the opportunity to be the lynchpin between an integrated East Asian market centered on China and a pan-Pacific market led by the United States. For that to happen, Suh proposes a four-step sequence: 1) early conclusion of the Korea-China FTA; 2) start of bilateral consultations with TPP members; 3) acceleration of the CJK FTA; and 4) creation of a reduced form of RCEP. This is a multi-level agenda, more ambitious than U.S. or Japanese goals, but it is also driven by a different geopolitical agenda than the other two states profess.

Zhang Xiaotong assesses Chinese thinking on TPP and even more on TTIP (Transatlantic Trade and Investment Partnership)—the FTA of trans-Atlantic scope—as well as on a Japan-EU FTA. In combination, these three steps toward high-order agreements are described as a rejection of multilateralism on the world stage in favor of selective regionalism driven by clear geostrategic reasons as much as geo-economic ones for the United States and Japan and geo-economic interests in the case of the EU. Zhang argues that China has been caught by surprise and slowly is beginning to respond, still hesitating between multilateralism and bilateralism. It has yet to make up its mind in the Asia-Pacific region on which path to prioritize. After assessing the various implications of the three mega-regional FTAs under negotiation to which China is not a party, Zhang orders its preferences as CJK FTA, RCEP, and last TPP. Specifying the costs from trade diversion effects resulting from each grouping that omits China, Zhang points to significant effects that China would try to mitigate. Again, technical economic assessments are combined with broader geostrategic considerations.

Chinese policy-makers are faced with three broad questions: multilateralism or bilateralism? competing bilateralism or harmonious bilateralism? further reform or turning inward? Zhang weighs the possible answers to each question, and broaches what is labeled the “big question,” whether to join the camp led by the United States, the EU, and Japan, or to establish its own camp of regional economic integration. If there seems to be no doubt that China prefers the latter, its prospects are uncertain, beginning with whether it can succeed in establishing a CJK FTA and RCEP. Zhang lists the variables as: China’s capacity, its political will, and how its interactions with Japan and the United States go forward. Yet, there is no hesitation in acknowledging that an equally fundamental factor is whether the government can garner sufficient domestic support for pushing through big FTAs and whether China’s reformers can establish a linkage between external pressure induced by the above-mentioned mega-FTAs and China’s own domestic reform agenda, still uncertain in its scope.

The four chapters in Section III say little about the consequences of failed TPP talks. They weigh the economic consequences of alternative agreements and TPP. There is descending order of commitment to TPP: the U.S. role as the driving force, Japan as a country with a strong need and interest, but uncertain will to overcome opposition from vested interests and politicians; South Korea with a desire for balancing entry into multiple FTAs, partly for geopolitical reasons; and China as the most suspicious of these countries, especially concerned about geopolitical consequences but intent on realizing economic goals too. The Asian countries are wary of U.S. loss of interest and also of being left behind in a rule-making process and a tariff-reducing process, where one's competitors may gain a substantial market advantage. All of the pieces point to the competitive nature of the pursuit of FTAs, particularly with the higher stakes introduced by TPP in a region rife with rivalry and eager to sustain a record of remarkable dynamism in trade in a new period when a slowdown seems likely.



# Asia-Pacific Regional Economic Integration: U.S. Strategy and Approach

Matthew P. Goodman

America's economic engagement in the Asia-Pacific predates the republic itself. In February 1784, the merchant ship *Empress of China* set sail from New York to Canton seeking to trade coins and ginseng for Chinese tea.<sup>1</sup> The profitable 15-month expedition sparked a wave of American merchant trade in the region.<sup>2</sup> It was not long before commercial considerations began to shape U.S. foreign policy in the region, as epitomized in 1853 by Commodore Perry's arrival in Tokyo Bay in his "black ships" seeking refueling rights for the American whaling fleet and the opening of Japan to trade. Over the ensuing 150 years, as trade and investment across the Pacific have grown to trillions of dollars a year, economic policy has become a central feature of broader U.S. strategy in the Asia-Pacific. Washington today pursues a robust, multilayered economic policy in the region that is designed both to promote U.S. growth and jobs and to underpin regional peace and stability.

While the United States has pursued an array of initiatives at the bilateral and multilateral level to advance its economic interests in the Asia-Pacific, for the past 25 years it has invested particular time and energy in regional initiatives. Starting with its co-founding of the Asia-Pacific Economic Cooperation (APEC) forum in 1989, Washington has been an active participant in regional economic integration, bringing a distinct approach to the effort. Like its recent predecessors, the Obama administration has put regional economic integration at the center of its Asia-Pacific strategy. Indeed, the overall success of the administration's policy of "rebalancing," or "pivoting," to Asia rests on its ability to carry out a successful regional economic strategy, in particular completion of a high-standard Trans-Pacific Partnership (TPP) trade agreement.

## THE ECONOMIC PULL OF ASIA

U.S. economic engagement in Asia is driven first and foremost by the numbers. The 21 member economies of APEC account for roughly 55 percent of global GDP.<sup>3</sup> The region contains the world's three largest countries by GDP—the United States, China, and Japan—and, counting India, half of the top 20 economies. According to the IMF in its most recent outlook, the Asia-Pacific is the fastest-growing region of the world, with real GDP growth in developing Asia expected to average 6.7 percent in 2014.<sup>4</sup> The APEC region also accounts for 44 percent of world trade, with nearly \$10 trillion worth of goods and services flowing around the Pacific last year.<sup>5</sup> U.S. exports to APEC economies, among which are six of its top ten trading partners, equaled nearly \$1.2 trillion in 2012, more than half of the U.S. total.<sup>6</sup> These have more than doubled over the past decade.

Financial flows across the Pacific in the form of both direct and portfolio investment are also substantial. The stock of U.S. FDI in Asia totaled more than \$650 billion at the end of 2012, an increase of some \$45 billion that year.<sup>7</sup> In the same year, nearly \$20 billion worth of FDI flowed into the United States from Asia-Pacific countries, adding to an accumulation of over \$400 billion invested here.<sup>8</sup> China and Japan each hold well over \$1 trillion of U.S. Treasury securities,<sup>9</sup> and Asians and Americans have trillions of dollars invested in each other's stock markets and other private financial instruments. This enormous volume of economic activity across the Pacific translates into jobs for Americans. According to one estimate, roughly 2.8 million American jobs were supported by exports to Asia in 2012.<sup>10</sup> Asia-Pacific companies



investing in the United States directly employed some 900,000 Americans in 2012 with several times that number of jobs supported indirectly by these operations.<sup>11</sup>

Asians overwhelmingly welcome U.S. economic engagement in the region. First, the United States has a lot to offer in commercial terms: the world's largest market, investment capital, technology, and innovative ideas. Second, as discussed further in the TPP section below, Asian countries may chafe at specific demands but broadly value U.S. leadership in shaping the region's economic rules, which support policy discipline and reform at home. Finally, the American military presence in the Asia-Pacific, while generally welcome as a stabilizing force, is seen as more acceptable if it forms part of broader U.S. participation in regional affairs, particularly in the economic domain.

Economic engagement in the Asia-Pacific also poses challenges. The United States has had large and persistent trade imbalances with a number of major Asian countries, including a \$299 billion deficit with China in 2013.<sup>12</sup> American companies face an array of barriers both at and behind the border in these countries, as well as policies that tilt the playing field toward domestic competitors. In addition, macroeconomic imbalances—including an excess of savings in many Asian economies—produce large financial flows from Asia to the United States that bring near-term benefits but may pose longer-term risks to the U.S. economy. These challenges require active U.S. policy engagement in the region.

## U.S. POLICY OBJECTIVES IN ASIA

Against this backdrop of opportunities and challenges, U.S. economic policy toward the Asia-Pacific region over the past several administrations has been driven by three broad objectives. The first is *promoting growth and jobs*. As one of the world's largest and fastest-growing economic areas, the region is an increasingly important source of demand for the U.S. (and global) economy. Stronger demand and growing purchasing power in Asia mean more U.S. exports, which in turn are a vital source of growth and jobs at home. For more than 30 years, the U.S. Treasury Department has worked to promote the macroeconomic objective of strong domestic-demand-led growth in large Asian surplus economies. Japan, then the world's second-largest economy, was the initial target in the 1970s-80s. Attention has broadened in recent years to other large, emerging economies with persistent current-account surpluses, notably China. With U.S. consumers and businesses forced to borrow less and export more in the wake of the 2008-09 financial crisis, Treasury has argued that large surplus economies need to consume and import more, or global growth will suffer. It has persistently criticized Asian governments that impede current-account rebalancing by intervening in foreign-exchange markets to keep their currencies weak. U.S. trade policy has complemented the macroeconomic growth agenda, including through the George W. Bush administration's initial negotiation of the KORUS FTA and the Obama administration's launch of the TPP negotiations. Enforcement of existing trade agreements has also been an increasingly important feature of trade policy in the past two administrations. These efforts have been designed to reduce barriers to U.S. exports, enhance America's own competitiveness, and boost growth and jobs.

The second broad objective of U.S. policy in the Asia-Pacific is *upholding and updating the rules of the international economy*. The open, rules-based system of trade and investment

championed by Washington since World War II has produced broad benefits not only for the United States but also for the rest of the world. But the prevailing rules are increasingly out of step with the realities of today's global economy, which is characterized less by cross-border trade per se than by integrated global value chains and digital connectivity. Asia is at the center of these trends. Over the past decade, the United States has sought to address the gap between rules and reality through the multilateral Doha Development Round negotiations launched by the WTO in 2001. Washington has been seeking to establish new "21<sup>st</sup> century" disciplines on behind-the-border issues that affect global supply chains, such as intellectual property protection, regulatory transparency, labor and environmental standards, and the investment regime. It has used regional mechanisms like APEC to catalyze and reinforce the multilateral efforts. As discussed further below, with the Doha Round floundering after a decade of negotiations, the Obama administration shifted emphasis toward regional approaches by launching the TPP negotiations in 2010.

The third objective of U.S. economic strategy in the Asia-Pacific is *supporting America's long-term presence in the region*. The United States is a Pacific power by nature, necessity, and design. Some 7,600 miles of the country's shores are lapped by the Pacific Ocean, more than three times the length of the Atlantic seaboard. The United States fought four hot wars<sup>13</sup> and one cold war in the Asia-Pacific theater between 1898 and 1975. Largely as a legacy of these conflicts, roughly 100,000 American troops remain deployed in the Pacific. The U.S. military presence is a vital source of stability in a region fraught with unresolved historical tensions and potential future conflicts, from North Korea to the South China Sea, and the United States is inextricably linked with the region through extensive trade and investment ties. To support these enduring interests, successive administrations since World War II have worked deliberately to embed the United States in the Asia-Pacific through an array of political, security, and economic arrangements. The network of alliances with Japan, South Korea, Australia, and others, and the troops and ships deployed in the region, are the most visible manifestation of that policy. Binding trade arrangements like the KORUS FTA and TPP can be seen as the economic equivalent of America's security alliances in the region; that is, they enmesh the country in regional affairs and give all Asia-Pacific countries an increased stake in each other's prosperity and security.

## LEVELS OF ENGAGEMENT

In support of all three objectives—growth, rulemaking, and long-term presence—recent U.S. administrations have pursued a multilayered approach to regional economic engagement, involving policy initiatives at all levels: bilateral, global, and regional. Bilaterally, administrations since the 1970s have conducted an active economic diplomacy with the major countries of the region. For example, the United States and Japan have established a plethora of bilateral processes to manage trade frictions and to encourage Tokyo to restructure its economy to generate sustainable growth.<sup>14</sup> Many contentious issues discussed in those forums—from restrictions on agricultural market access to allegedly favored treatment of Japanese automakers—remain at the heart of the TPP negotiations today.

As the relative weight of China in policy toward Asia has increased in both economic and political terms, Washington has established similar bilateral arrangements with Beijing. In

addition to the longstanding Joint Commission on Commerce and Trade (JCCT), which seeks to manage trade frictions and expand commercial opportunities between the two countries, the George W. Bush and Obama administrations have established high-level “strategic” dialogues to discuss broader, longer-term economic challenges and opportunities in the bilateral relationship. Along the economic track of what is now known as the Strategic & Economic Dialogue (S&ED), the Obama administration has sought to encourage more balanced growth in China, promote financial liberalization and a more flexible currency regime, and advance negotiations toward a bilateral investment treaty (BIT).

Other major Asian economies have also been the target of U.S. economic diplomacy over the past two administrations. With South Korea, the KORUS FTA has been the organizing principle for bilateral economic relations over the past decade. The Bush administration also negotiated FTAs with Singapore and Australia, and economic dialogues have been held with these and other important regional players such as India and Indonesia.

Engagement *at the global level* is another implicit element of Washington’s Asian economic strategy. The Clinton and George W. Bush administrations worked to bring China into the WTO to more deeply embed it in the global rules-based system. For its part, the Obama administration embraced the G-20 as the premier forum for international economic cooperation in 2009 and has worked within that group to encourage strong, stable, balanced growth in Asia-Pacific economies, which make up roughly half of the G-20’s membership. The United States engages bilaterally and through global institutions with most major countries of the world, but what has made U.S. economic policy toward the Asia-Pacific distinct is that it invests heavily in engagement *at the regional level*.

## REI: THE U.S. APPROACH

Presidents since George H.W. Bush have deliberately sought to tap into and shape aspirations in the Asia-Pacific for regional economic integration. (The concept has such currency in regional affairs that it has its own acronym: REI.) For a quarter century, APEC has been the organizing framework for U.S. REI efforts. It was founded in 1989 when Secretary of State James Baker embraced his Australian counterpart’s proposal to create a venue for foreign ministers from across the region to discuss trade and investment liberalization. APEC does not negotiate binding agreements but tries to develop consensus around voluntary efforts to eliminate frictions in the regional trading system. Where member economies are ready to move forward faster toward integration, APEC allows for this through a “pathfinder” approach; TPP is effectively a pathfinder initiative among 12 of APEC’s 21 members. Rather than create different tiers of members based on state of development, APEC offers less-developed members help in building capacity and working toward more open trade.

APEC’s footprint and ambition have grown in a quarter century. From 12 founding members in 1989, it now includes 21 economies from around the Pacific Rim.<sup>15</sup> It was given top-level political imprimatur in 1993 when Clinton invited his counterparts to a summit on Blake Island off Seattle. In 2007 APEC set an ambitious vision for the endpoint of its REI efforts: a Free Trade Area of the Asia-Pacific (FTAAP). While that goal remains a long way off, APEC has done useful pick-and-shovel work in removing operational barriers to trade, and created

valuable networks among officials across the region. It has also served as an incubator for broader liberalization efforts at the regional and global level, e.g. APEC leaders agreed in 2011 to reduce tariffs on environmental goods below 5 percent by 2015, following years of failure at the multilateral level to agree on the definition of an “environmental good.”

Washington’s support for APEC reflects two distinct characteristics of its approach to regional economic integration: a preference for trans-Pacific rather than Asia-centric mechanisms, and an emphasis on comprehensive liberalization and high-standard rulemaking. The trans-Pacific nature of the U.S. approach to REI is, of course, largely driven by geography: the United States is a Pacific but not an Asian country, but higher-level policy considerations also play a part. In promoting APEC, Baker was clearly animated by concerns about East Asian aspirations for community building that would exclude the United States; he later noted that such efforts would “draw a line down the middle of the Pacific.”<sup>16</sup>

Strategic considerations in the Western Hemisphere have also played a part in U.S. insistence on including Pacific-facing Latin American countries in regional economic integration efforts. Clinton invited the Mexican president to the Blake Island summit and soon after championed Chile and Peru’s membership in APEC. It is no coincidence that the TPP negotiations include all five APEC economies in the Western Hemisphere: Canada, Chile, Mexico, Peru, and the United States. In addition to strengthening political ties with these countries, Washington wants to pull them into Asia-Pacific REI efforts because of their generally liberal views on trade and support for U.S. positions.

The second distinguishing feature of the U.S. approach to regional economic integration is its emphasis on comprehensive liberalization and high-standard rules of the road. This has inspired Washington’s approach to APEC since the inception but took on new weight with the launch of “21<sup>st</sup>-century” treaty negotiations with Korea and the TPP partners. The George W. Bush and Obama administrations have insisted on the broadest and deepest possible liberalization, as well as state-of-the-art disciplines on trade and investment-related policies both at and behind the border. By contrast, Asia-only integration initiatives, including bilateral and sub-regional FTAs, have generally covered only border measures and included numerous exceptions to full liberalization. A mix of economic and political considerations lies behind this interest in removing most impediments to trade and investment and imposing tough rules of the road to maximize economic efficiency and growth. Washington believes that the narrower and “shallower” agreements reached to date in Asia have done little to improve efficiency. The Obama administration also worries that low-standard agreements may pose a threat to U.S. competitiveness. As U.S. Trade Representative Michael Froman said in an interview in late 2013, “A race to the bottom is not a race we can win.”<sup>17</sup>

Domestic political support for trade agreements in the United States increasingly hinges on not only breaking down barriers to U.S. exports but also advancing other policy objectives such as enhanced labor rights, environmental regulation, and intellectual property protection. These issues are among 147 negotiating objectives listed in trade promotion authority (TPA) legislation tabled in both houses of Congress in January 2014. Without substantial progress on these issues, it is unlikely that a final TPP deal will be approved

by Congress. Thus, the U.S. insistence in the TPP negotiations on a “high-standard, 21<sup>st</sup> century agreement” reflects the realities of trade politics at home.

The above two characteristics of the U.S. approach to REI explain its cool attitude toward the other major track of trade negotiations in the region, the Regional Comprehensive Economic Partnership (RCEP), which is purposefully Asia-centric, thus far not including any countries from the eastern Pacific. Insofar as it appears focused mainly on tariffs and other border measures and is likely to contain numerous exceptions to full liberalization, it does not pass the U.S. test of being “high standard” and “21<sup>st</sup> century.”

## THE TRANS-PACIFIC PARTNERSHIP: FACTS AND MYTHS

At least for now, Washington has put all its weight behind TPP as the centerpiece of its REI strategy in the Asia-Pacific region and its preferred path to APEC’s vision of an FTAAP. In fact, as discussed below, TPP has moved to the heart of broader Obama administration strategy in the Asia-Pacific, but it did not start out that way. TPP was conceived in the waning days of the George W. Bush administration, when the White House notified Congress of its intention to negotiate a trade agreement with four small, open APEC economies: Brunei, Chile, New Zealand, and Singapore. Known as the Pacific-4 (P-4), these countries had already reached their own FTA a few years earlier. In keeping with its search for “coalitions of the willing,” the administration decided to dock onto this group of pro-trade countries as the next step in its regional trade policy following initial completion of the KORUS FTA in 2007.

After roughly a year of consideration, the Obama administration decided to embrace TPP in late 2009 as an element – though not yet a dominant one – of its regional trade strategy alongside a renegotiated KORUS. Australia, Peru, and Vietnam also joined the partnership, and the eight original countries launched formal negotiations in March 2010. Malaysia joined the talks later that year, Canada and Mexico came aboard in 2012, and Japan came to the table in the summer of 2013, bringing the number of participants to 12.

As of this writing, TPP negotiators have held over 20 rounds of talks but have been unable to reach final agreement. Although most of the agreement’s 29 chapters had reportedly been closed by the middle of 2013, significant differences among the parties remained on a number of contentious rulemaking issues, including intellectual property protection, state-owned enterprise disciplines, and environmental standards. In addition, substantial gaps remained on the market-access provisions, notably those revolving around Japan’s restrictions on access to its agricultural market. Despite a renewed mandate at the October 2013 APEC Leaders’ Meeting in Bali to complete the negotiations by the end of the year, TPP trade ministers were unable to reach agreement at their December meeting in Singapore. However, by all accounts there remained a shared sense of determination in the room to wrap up the talks as soon as possible, and Obama’s planned trip to Asia in April presented an early action-forcing event that was expected to put pressure on negotiators to reach a final deal.



As this author has argued elsewhere, a number of myths cloud regional perceptions of TPP.<sup>18</sup> One is that the negotiations are “splitting Asia,” since not all Asian economies are eligible to join, while those that are eligible must “choose” between joining TPP, viewed as led by the United States, and RCEP, the alternative track supposedly preferred by China. On the first point, as an initiative housed within APEC, TPP is an approved pathway to FTAAP and is in principle open to any APEC economy willing to strive for high-standard rules. Indeed, several APEC members—including Korea, the Philippines, and Taiwan—have publicly expressed interest in joining TPP, and even China quietly began studying the possibility after Japan joined in the summer of 2013. Conceptually there is no reason that even non-APEC economies like India and Myanmar should forever be excluded from TPP. The Obama administration has been preparing the ground for such an expansion. In 2012, it launched an Enhanced Economic Engagement (E-3) initiative with ASEAN. By building capacity on TPP-related disciplines in smaller ASEAN members—notably the three non-APEC members, Myanmar, Cambodia, and Laos—, E-3 is designed to bring all 10 members of the group into a high-standard trade arrangement with the United States.

As for having to “choose” between TPP and RCEP, the seven countries participating in both negotiations clearly view the two approaches as compatible. Moreover, TPP and RCEP could one day converge in a region-wide agreement, or at least become interoperable, with potential annual gains to world income as high as \$2.4 trillion by 2025.<sup>19</sup> In a November 2013 report, CSIS proposed that China, as APEC host in 2014, expand the forum’s existing work on supply-chain connectivity in an effort to begin the process of stitching together the quilt of trade agreements in the region and making them interoperable.<sup>20</sup>

Another myth that until recently was popular in Beijing is that TPP is part of an effort by Washington to “contain” China. Yet no Asia-Pacific country—including the United States—wants to exclude China from regional integration; on the contrary, all want to deepen their economic ties with the world’s second-largest economy. To be sure, one goal of TPP is to create a level playing field that, among other things, will allow other countries to better compete with China; however, this is a far cry from “containment.”

In the first half of 2013, elite opinion in Beijing began to shift from rejecting TPP outright to seeking a better understanding of the negotiations. There were signs—such as Beijing’s willingness to negotiate a comprehensive BIT on the terms proposed by Washington, as well as the launch of a free trade zone in Shanghai in late September—that China’s leadership was preparing the ground for eventual membership in a high-standard regional agreement, if not TPP itself. This helps to dispel a third myth, i.e., that the high standards Washington is espousing in TPP are too ambitious for Asia. All participants have made clear that they believe there are substantial welfare gains to be had from a high-standard agreement that opens up new market opportunities and helps each country address structural impediments in its own economy. Vietnam, for example, is often thought to be the main obstacle to agreement on TPP’s state-owned-enterprise (SOE) chapter; yet Hanoi clearly recognizes that its SOEs need discipline if the country is going to fully enjoy the benefits of a market-based economy.<sup>21</sup> China, too, has made market discipline of its SOEs an organizing principle of economic reforms announced in the fall of 2013. Its more positive attitude toward TPP likely reflects a calculated desire to use external pressure to drive domestic reform, as it did with WTO accession over a decade ago.

## TPP AND THE “ASIA REBALANCE”

TPP exemplifies both key characteristics of U.S. REI strategy. It is trans-Pacific in nature, incorporating both Asian and Western Hemisphere countries, and it is explicitly designed to produce, as Obama said in announcing his embrace of TPP in late 2009, “the high standards worthy of a 21<sup>st</sup>-century trade agreement.”<sup>22</sup> TPP is also consistent with the three enduring objectives of U.S. economic policy toward the Asia-Pacific discussed earlier. Its explicit aim is to stimulate American growth and jobs. According to the Office of the U.S. Trade Representative, “Through this agreement, the Obama Administration is seeking to boost U.S. economic growth and support the creation and retention of high-quality American jobs by increasing exports in a region that includes some of the world’s most robust economies and that represents more than 40 percent of global trade.”<sup>23</sup> The welfare gains to the United States and the world from a completed TPP agreement could be substantial. According to one estimate, agreement among the 12 current members could generate annual income gains for the United States of some \$77 billion by 2025, and for the world as a whole of \$223 billion.<sup>24</sup> These gains would be increased several-fold if TPP ultimately led to a broader regional free trade area.

TPP is also aimed at strengthening the rules of the regional trading system. Establishing new disciplines on an array of behind-the-border measures that impede trade and investment such as excessive or non-transparent regulation, preferences for SOEs, and inadequate intellectual property protection, Washington hopes through TPP to ensure open markets in the region and a level competitive playing field. An unstated objective is to do this on U.S. terms before the lure of China’s large market tilts the rulemaking table in Beijing’s favor. Moreover, the administration clearly hopes that, if successful, TPP will become the driver and *de facto* template for a new global system of rules on trade and investment. Having failed to achieve this objective via the first-best route of multilateral negotiations under the Doha Round, it is trying to find another path to the multilateral summit by way of TPP and a similar high-standard agreement under negotiation with the EU, the Transatlantic Trade and Investment Partnership (TTIP).

Arguably the most important objective of TPP is to embed the United States more deeply in regional affairs. Indeed, it is not an exaggeration to say that TPP has become the *sine qua non* of the Obama administration’s strategy of “rebalancing” (or “pivoting”) to the Asia-Pacific. From its earliest days in 2009, it has put the Asia-Pacific at the center of its foreign policy. This was signaled at a symbolic level when Hillary Clinton made her first overseas trip to the region as secretary of state, and when President Obama received the Japanese prime minister as the first foreign visitor to the Oval Office. Early substantive decisions then gave weight to the policy, with the announcement in 2010 that the president would join a second regional leaders’ forum alongside APEC, the East Asia Summit, and with the launch of TPP.

It was not until the fall of 2011 that the administration first gave voice to the rebalance as the defining feature of its policy and posture in the Asia-Pacific. Hillary Clinton’s article in *Foreign Policy* magazine said that the United States “stands at a pivot point” after a decade fighting two wars in Iraq and Afghanistan; going forward Washington would “lock in a substantially increased investment—diplomatic, economic, strategic, and otherwise—in the region.”<sup>25</sup> She identified six dimensions of what came to be known as the rebalance:

strengthening alliances; deepening relationships with emerging powers, including China; engaging with regional institutions; expanding trade and investment; forging a broad-based military presence; and advancing democracy and human rights.

Insofar as these were longstanding elements of U.S. strategy in the region spanning several administrations, the rebalance was nothing radically new. But the packaging by the Obama administration clearly represented a significant raising of the stakes. To make good on that rhetoric, the administration must put new, substantive meat on the bones of the rebalance and ensure lasting follow-through. This is where the economic elements emphasized by Clinton in her *Foreign Policy* article come into play. America's security role in the region is enduring, but in light of both budget realities and strategic force-posture considerations, a substantially increased U.S. military footprint in the region is unlikely. Diplomatic endeavors, meanwhile, come and go, but economic engagement holds the promise of introducing a new, substantive, and enduring element to the overall rebalancing strategy. And TPP is the sharp end of the spear of U.S. economic engagement in the region.

Thus, the stakes involved in TPP could not be higher for the Obama White House. Conclusion of a deal is the sine qua non of success not only for the administration's regional economic policy but for the entire Asia rebalancing strategy. In addition to its economic benefits, a successful agreement would anchor the United States more firmly in the Asia-Pacific and bolster American leadership there. Without TPP, the rebalance would contain little of substance that is new and would likely be perceived in the region as driven primarily by military considerations.

## CONCLUSION

America's interests in the Asia-Pacific are broad, deep, and enduring. None is more important than the U.S. economic stake in the region. As Hillary Clinton explained in laying out the rationale for the rebalancing strategy, "Harnessing Asia's growth and dynamism is central to American economic and strategic interests and a key priority for President Obama. Open markets in Asia provide the United States with unprecedented opportunities for investment, trade, and access to cutting-edge technology. Our economic recovery at home will depend on exports and the ability of American firms to tap into the vast and growing consumer base of Asia."<sup>26</sup>

A successful economic strategy in the Asia-Pacific is essential to sustaining American growth and jobs into the 21st century. It is also central to Washington's efforts to remain a champion of the global rules-based order and underpins America's long-term presence in the Asia-Pacific, which in turn contributes importantly to the region's security and prosperity. For all these reasons, the United States is likely to remain an active—even impatient—participant in regional economic integration efforts in the vital Asia-Pacific region.

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# Japan and Regional Integration Dominoes: Golden Opportunity or Another Political Failure?

Takashi Terada

The re-election of Abe Shinzo as prime minister has led to a drastic change in the economic landscape of Japan through the implementation of “Abenomics.” Abe’s decision to promote monetary easing as a tool to help Japan overcome deflation, which had stalled the Japanese economy for more than a decade, greatly contributed to a 50 percent surge in the Nikkei stock index and to a nearly 20 percent depreciation of the yen against the U.S. dollar by the end of year 2013. A key remaining element of Abenomics is to participate in a regional integration framework and utilize it as an effective vehicle to push a domestic reform agenda, including agricultural liberalization, while expanding export markets for further economic growth. Several such frameworks have emerged since 2010, and Japan has entered negotiations in all of them, presenting a golden opportunity for its trade and investment. With ASEAN aiming to establish an economic community in 2015, four frameworks are being negotiated in East Asia and the Pacific, including the three-way CJK FTA, the 16-nation RCEP, and a U.S.-led TPP. Japan also began FTA negotiations with the EU in 2013, which has entered into TTIP negotiations with the United States, possibly disseminating trade and investment policy norms based on those of the developed countries.

A principal factor behind the emergence of the multiple regional integration initiatives is the power competition between the United States and China. Though the United States long remained on the sidelines of East Asian integration initiatives, it is now seeking high-quality “WTO-plus” regional integration through TPP, while China’s commitment to regional integration frameworks such as RCEP is strongly oriented towards developing countries and would allow for more exemptions in the form of tariff elimination duties, with few deregulation requirements for the reform of domestic economic systems. As ASEAN has also shown an interest in RCEP, in which the speed and level of liberalization would be based on the standard that developing countries generally prefer, the dissimilarities in these integration models in East Asia and the Pacific make any future merger of TPP and RCEP difficult. This means that the Sino-U.S. competition over trade and investment rule-making is likely to continue.

This article examines how these intertwined regional integration frameworks arose and what kind of trade policy Japan has adopted under these circumstances through an analysis of its views on the development of TPP, RCEP and CJK FTA, respectively. This profusion of regional integration initiatives seems to present a “golden opportunity” for the Japanese economy, but it results, as argued below, from the U.S. push for TPP. This caused China to quickly make concessions that enabled trilateral FTA talks with Japan and South Korea, as well as RCEP, to commence. While the emergence of multiple regional integration frameworks is seen as desirable for Japan, it needs to surmount challenges in domestic politics including agricultural liberalization to play a proactive role in any regional integration framework.

## FTA DOMINOES AND JAPAN’S REGIONAL INTEGRATION POLICY

A domino theory, often used to explain FTA proliferation, focuses on trade diversion from the exclusive nature of FTAs. Benefits brought to a party through an FTA, such as the elimination of tariffs, generally victimize a third country not included in the agreement. This means a third country’s products that are more competitive in terms of quality and price will

be replaced by the FTA country's less competitive products thanks to the FTA, which will negatively affect consumers of the FTA countries, while exports from the third country to the FTA countries will be blocked and reduced.<sup>1</sup> While tariff-free privileges will be granted to companies in the FTA countries, third country companies will be placed at a competitive disadvantage, which will spur business and interest groups to lobby the government to conclude an FTA, and as a result, FTA negotiations will begin, which in turn will cause a domino effect of proliferating FTAs.<sup>2</sup>

The crux of this argument is the difference in economic power of FTA negotiating countries. As Bhagwati indicates, all countries do not wield an equal amount of power; one country may be a major military or economic power, and thus have greater influence on another, so we often see a pattern where FTAs move forward due to the interest and influence of such hegemonic powers.<sup>3</sup> In the case of FTAs signed by powerful countries, since certain third countries will have their market access inhibited, trade diversion concerns become clearer, which motivate another country to conclude an FTA with the same major power. In this sense, even if small and medium-sized countries conclude an FTA together, this will not necessarily cause trade diversion concerns, and even if a major economic power were inhibited as a third country, this major power can be said to have few motivations to conclude FTAs with these small and medium-sized countries. In other words, the FTA domino effect will not occur.

Before the intertwining of frameworks took place, regional integration in East Asia and the Pacific was characterized by a proliferation of bilateral FTAs. They can be grouped into four categories: 1) bilateral FTAs centered on Japan with individual countries of ASEAN; 2) ASEAN+1 FTAs centered on ASEAN (with Japan, China, South Korea, India, and Australia/New Zealand); 3) FTAs in Northeast Asia including Taiwan centered on China; and 4) FTAs started by South Korea with the non-Asian large economies including the United States and the EU. Each of the four types has its own central country (or region), but proliferation can be explained using the domino theory.

For instance, the proliferation of bilateral FTAs centered on Japan with individual countries of ASEAN was a result of major ASEAN members' selection of Japan as their first bilateral FTA partner.<sup>4</sup> For example, Malaysian Trade Minister Rafidah Aziz sharply criticized Singapore's moves to conclude discriminatory FTAs with major powers outside the region as an action that would damage the solidarity of ASEAN, and stated that Malaysia, unlike Singapore, is "not interested in having bilateral FTAs with anybody."<sup>5</sup> However, Malaysia and Indonesia, both of which had been considered to be the most hesitant in the region toward bilateral FTAs, began to study the strengths and weaknesses of the Japan-Singapore FTA after the negotiations for a Japan-Singapore FTA started, and showed an interest in an FTA with Japan. For Malaysia and Indonesia, Japan was already one of their most important trade and investment partners, and was also the largest provider of economic assistance. Both countries considered Japan's huge market and purchasing power in recognizing the importance of being able to access this market tariff-free through concluding an FTA, and also anticipated that such an FTA would make it possible to shift capital and technology from Japan to each. As a result, Prime Minister Mahathir announced that Malaysia had begun negotiations with Japan for an FTA when he visited Japan in December 2002, while President Susilo Bambang Yudhoyono had agreed to negotiate Indonesia's first FTA with Japan upon his visit to Japan in June 2005.

It was South Korea that spurred Japan to develop an interest in TPP centered on the United States and an FTA with the EU, Japan's two major trading partners apart from China. Although South Korea is an exception to the above-mentioned explanation of FTA proliferation, its decision to sign bilateral FTAs with the United States and the EU resulted in a situation where Japan, which competes in major export goods, particularly automobiles and electric appliances, was forced to follow suit. South Korea's FTA strategy targeted its large export markets. Having FTAs with 45 countries including the United States, "the economic territory of South Korea is the best in the world,"<sup>6</sup> said President Lee Myung-bak.

A source of real concern to Japanese industry was the FTA concluded between South Korea and the EU. Japanese companies had yet to establish extensive production bases in the EU, while the tariff rate on competing products was relatively high (LCD TVs at 14 percent, automobiles at 10 percent). Preventing price disadvantages with South Korean competitors was a major motivation for Japan to sign a similar FTA with the EU. The day after FTA negotiations began between South Korea and the EU in May 2007 the Japanese Business Federation (*Keidanren*) called for a Japan-EU EPA.<sup>7</sup> However, the EU judged that an FTA with Japan would not be advantageous, and so did not respond to Japan's requests for a long period of time. Of the automobiles exported to the EU in 2009, Korean ones made up 12 percent of the total, while Japanese were 36 percent. It was felt that if tariffs were eliminated for Japanese automobiles, which had advanced green technology such as hybrid vehicles, it would be a threat to similar types of European cars. Also, along with the normalization of the EU trade deficit with Japan (€32.8 billion in 2008, €19.9 billion in 2009), about 70 percent of EU exports were already tariff-free. As a result, the EU considered the benefits of an FTA with Japan to be small.<sup>8</sup> However, after Japan showed an interest in TPP in October 2010, the EU's attitude began to change. It was interested in regulatory easing in non-tariff barriers, as seen in the lower level of inbound investment in Japan, and not being able to bid in government procurement. Easing or eliminating domestic regulations is a major task in TPP led by the United States, heightening EU expectations that it could also put the elimination of non-tariff barriers for exports and investment on the negotiating table.

The EU has chosen potential Asian FTA partners who have participated in TPP talks, such as Singapore, Malaysia, and Vietnam or signed an FTA with the United States such as South Korea, so the EU FTA strategy can be seen to have the characteristic of "chasing the US."<sup>9</sup> Accordingly, Japanese participation in TPP opened the path to an FTA with the United States and the EU, signifying responsiveness to the requests made by exporting industries in Japan to catch up to Korea's aggressive FTA policy.

## JAPAN AND TPP

The Obama administration's "rebalancing to Asia" stresses the importance of TPP as a major trade policy. Secretary of State Clinton stated that the United States would strengthen its economic leadership in order to maintain its strategic leadership in the Asia-Pacific region,<sup>10</sup> signifying determination to incorporate as many countries as possible in TPP to build the desired economic order in the region. Ian Bremmer writes, the United States "encouraged Japan to join hands with the U.S. and strive to nurture the TPP into a new WTO, with a belief that if the TPP becomes a strong presence, China will eventually have no choice but to

submit to its rules.”<sup>11</sup> China’s large presence looms behind the U.S. intention to proceed with economic leadership. It is seen as the “shadow negotiating partner” of the TPP. For example, in April 2011, six industry groups sent a letter to U.S. Trade Representative Kirk requesting that a punitive obligatory provision with legal binding force be added to the TPP in response to overseas state-influenced entities that improperly obstruct the economic activities of private businesses. Although state-operated corporations exist in highly-liberalized countries such as Singapore too, a U.S. business participant stated that “limiting business practices and subsidies to state-owned corporations through the TPP would act as a weight on the active ties of Chinese businesses in the Asian market, and in the future, will provide a policy framework that will be the cornerstone of trade negotiations at the bilateral, regional, and global level with China.”<sup>12</sup> In other words, there exists a sense of hope that the TPP will be a means for applying legal shackles to China, whose business practices are not free capitalist ones. The participation in TPP by Vietnam, another socialist country where state-operated enterprises are rampant, is construed by the United States as playing the role of a virtual China. With Japan’s economy twice the size of the then eight countries participating in TPP negotiations with the United States, Japan’s potential entry was viewed as important for the pact’s emergence as the preeminent trade agreement in the Asia-Pacific.

Prime Minister Noda Yoshihiko announced Japan’s participation in the TPP in November 2011 by stating “I have decided to enter into consultations toward participating in the Trans-Pacific Partnership negotiations with the countries concerned.” Japan focused on the pact’s WTO-plus orientation with a belief that unless it joined soon, it would have no influence in shaping the agreement, including on matters of critical importance to Japanese companies such as rules of origin and intellectual property rights.<sup>13</sup> The LDP’s Abe made the final decision on Japan’s participation in TPP soon after his meeting with Obama in February 2013. A key factor making it possible to commit to negotiations was Obama’s assurance of no preconditions for tariff elimination, interpreted in Japan as U.S. approval for the maintenance of tariffs on sensitive agricultural products such as rice to be shielded from TPP’s free trade package.

Although Japan expected to work together with the United States to complete TPP negotiations, it faced a dilemma stemming from American power. As a newcomer to the negotiations, it was required to establish bilateral pre-negotiations with all existing members individually to obtain approval for entry. This condition is a weapon the United States can utilize to require any newcomer, even China, to deal with areas that are of specific interest to it, meaning, in effect, it has veto power over the newcomer. The United States established three major conditions for Japan’s entry to the TPP, and one of them was that Japan’s state-owned life insurance company, Kampo, should not expand its insurance operations. TPP is a multilateral negotiation, and an agreement can only be reached through give and take among all participating countries, but the preliminary negotiation is bilateral, unilaterally obliging applicants to accept specific demands by the existing members, especially the United States, as a condition for entry to TPP.

Another feature of bilateralism in TPP is related to market access negotiations. Japan’s expectations from a change from bilateral FTAs to regional integration is the expansion of countries that are the subject of cumulative origin, which have the benefit of increasing the number of goods for which no tariff is applied, simplifying the rules for that purpose, and



ultimately contributing to an expansion in exports. Japan's Ministry of Economy, Trade and Industry also emphasizes this merit for companies which have expanded their supply-chain networks in the region.<sup>14</sup> The different product coverage and distinctive time framework of liberalization in a number of bilateral FTAs would make it difficult for those multinational companies as potential FTA users to identify which FTA or regional integration frameworks could be most effective in cost-saving for their business. Thus, a “spaghetti bowl” effect, meaning a large number of rules of origin with specific standards and involving specific procedures, would follow, and different rules applied to a single commodity would emerge as one of the most significant concerns. Yet, the United States has little intention to help address this issue, and the market access negotiations in TPP have been established as bilateral rather than multilateral tracks among 12 countries. This leads to preparation of more than 50 to 60 bilateral agreements, simply confusing multinational companies and greatly reducing the TPP's usefulness and Japan's interest.

## TPP, CHINA, AND ASEAN: BETTER EMERGING CONDITIONS FOR JAPAN

Japan's inclination toward TPP contributed to China making concessions over the issues long contested by Japan, culminating in the emergence of favorable trading circumstances for Japan's regional integration policy. The level of China's concerns about the negative impact TPP might have on its regional integration policy is seen in the fact that as soon as Japan expressed an interest in joining TPP, China quickly became more flexible in its own talks with Japan. For example, China accepted a proposal from Tokyo to conclude a trilateral investment agreement first among China, Japan, and South Korea, a framework that Beijing had previously resisted due partly to required protections for Japanese and South Korean investors. China has also moved away from exclusive pursuit of an ASEAN + 3 regional framework, toward interest in the ASEAN + 6 framework, Japan's preferred arrangement. These two concessions led to the start of official negotiations for the trilateral FTA and RCEP in 2013.

These concessions can be viewed as a way for China to limit America's regional influence, a significant outcome of Washington's push for, and Japanese participation in, TPP. The extent of China's concerns is evident in the frequent requests it has made to participants, especially the United States, to be open and transparent about the TPP negotiations—something that so far has not really happened. The dilemma that China faces is straightforward: to join TPP is difficult, because it includes a range of so-called 21<sup>st</sup> century issues such as regulatory convergence, treatment of state-owned enterprises, the issue of supply chains, and intellectual property rights. Yet, the cost of not participating could quickly escalate as more countries, especially major economies like Japan, create a critical mass toward a truly Asia-Pacific trade arrangement.

The TPP development has also caused ASEAN to more strongly push for a single market because TPP splits ASEAN. Since the Philippines has now studied all the pros and cons of TPP, the likelihood of there soon being five participating countries from ASEAN has increased. This division would cast doubt on ASEAN's ability to continue to place a high priority on ASEAN centrality, adding to the impression of an ASEAN rift. The then

Indonesian Trade Minister Gita stated that TPP is not a threat to ASEAN, and the selection of an integration framework differs according to the conditions in each member of ASEAN, but since TPP allows virtually no exceptions to tariff elimination, Indonesia would have many problems; so there are no plans to participate.<sup>15</sup> This statement indicates that as a result of the advent of TPP, countries sharing a vision for regional integration will proceed with domestic reforms and a high level of liberalization as they participate, and the “lowest common denominator” approach to liberalization will no longer be applied. This is encouraging for Japan’s regional integration policy. Japan, especially METI, was well aware of the lowest common denominator problem, where the actions of liberalization-oriented countries are blocked by the least enthusiastic country, limiting regional integration in ASEAN. Japan and China, which had until then been competing over whether ASEAN + 3 or ASEAN + 6 should be the framework for East Asian integration, set their dispute aside in August 2011 and jointly proposed the founding of a working group to promote the liberalization of trade and investment in East Asia. This joint initiative stemmed from concerns on the part of both large economies that while TPP negotiations were progressing (Japan had not been a member yet at that time), East Asian integration frameworks would not make progress if left up to ASEAN. ASEAN’s sense of urgency for the creation of a single market triggered by the TPP development was welcomed by Japan.

RCEP, unlike TPP, places a higher priority on development, technical cooperation, and flexibility on liberalization because it is based on ASEAN + 1 FTAs. Japan’s interest in RCEP stems partly from its desire to be involved in the growth of the ASEAN economy, one of the most potentially promising markets in the world. Abe sees it as “a growth center of the world” and stressed that Japan has two major goals for its ODA to the region: ASEAN’s own economic development and Japan’s renewed economic growth. This interest has also been demonstrated by its private sector. According to a survey by the Japan External Trade Organization (JETRO), by value, 17 percent of Japanese multinational companies’ overseas deals in 2013 have been made in ASEAN member economies, compared with 3 percent in 2012.<sup>16</sup> Their FDI in ASEAN has also been rapidly growing, reaching \$13 billion in the first nine months of 2013, more than the \$10.6 billion for the whole period of 2012. Assistance in ASEAN’s integration projects is relevant to Japan’s own interests. In sum, Japan does not see ASEAN as a regional integration project similar to the EU or NAFTA, and thus it is not interested in developing RCEP, based on ASEAN’s flexibility approach, into a rule-making framework like TPP. Yet, Japan is well aware that RCEP cannot be an attractive regional integration framework without ASEAN’s sound development. This is a rationale behind Japan’s commitment to assisting ASEAN’s effort to promote regional integration or the formation of a single market to attain higher economic growth.

## TRILATERAL COOPERATION AND JAPAN

Japan has also participated in talks about a trilateral FTA with China and Korea. The growth of Northeast Asian regionalism has become more sluggish because of Japan’s relationships with both of them. Yet, at the 5th Trilateral Summit held in Beijing in May 2012, the Trilateral Investment Treaty, after thirteen rounds of negotiations since 2007, was signed and it became effective on May 17, 2014. Japan was deeply reluctant to sign a trilateral FTA without this, while China long asserted the reverse sequence. This difference was one source of delay

in commencing official FTA negotiations, and as mentioned earlier, China's concession occurred only after Japan's interest in TPP surfaced in 2011.

Japan's interest in an investment treaty rather than an FTA in Northeast Asia was already revealed in 2004 when Koizumi proposed at the Trilateral Summit in Bali in October 2004 that research on a trilateral investment arrangement be conducted through an industry-government-academia collaboration. For Japan, an FTA has long been considered difficult; liberalization of agricultural products has been the chief stumbling block. This would be the case in deals with China and Korea too, whereas the investment treaty is greatly desired by the business community and, moreover, it entails no comparable political sensitivity. However, China was hesitant to promote an investment treaty because of its content, such as regarding "national treatment," in which foreign companies receive equal treatment to domestic companies in terms of taxation and bidding procedures. The investment chapter, which all of Japan's bilateral FTAs include, prohibits preference for local contents and certain investment restrictions, as well as the protection of intellectual property. Cui Tiankai, Director of Asian Affairs at the Ministry of Foreign Affairs, thus said, "a normal procedure should first be the trade liberalization, and then the investment arrangement."<sup>17</sup>

Narrowing the gap among the three countries on trilateral cooperation was a lengthy process. Official negotiations toward a trilateral investment treaty finally commenced in March 2007, but some events slowed progress on FTA negotiations, such as the China-Japan clash in the East China Sea in September 2010 and the Great East Japan Earthquake in March 2011. This impasse was finally broken by the U.S. and Japanese push for TPP. China suddenly encouraged Korea to pursue a China-Korea FTA during the visit of Lee Myung-bak in January 2012, which the two sides had never seriously considered before,<sup>18</sup> partly as a means of pressuring Japan into approaching the trilateral FTA more seriously, given the prospect of Japanese exports being disadvantaged in the gigantic Chinese market because Korean manufacturing products would enjoy non-tariff status, as already had happened in the EU and U.S. markets.<sup>19</sup>

Japan's expectations for the trilateral investment treaty seem overstated. According to METI, while the treaty would accelerate investment among the three countries and contribute to their economic growth, it was expected to achieve high-standard protection for investments through clauses on the protection of intellectual property rights (IPR), prohibition of unauthorized technology transfer and rejection of local content requirements, as well as the fulfillment of the Investor-State Dispute Settlement (ISDS) and fair and equitable treatment.<sup>20</sup> However, while the treaty's function of investment protection can go forward, investment liberalization would be limited since the treaty could only apply to future investment. As for pre-establishment national treatment, which eliminates barriers for newly arriving businesses, it cannot resolve Japanese enterprises' longstanding problems in China, including discriminatory requirements for foreign investors on the need to establish a joint venture with their Chinese counterparts.<sup>21</sup> This passage remains in the treaty thanks to China's strong insistence.

The treaty's effectiveness for the protection of IPR is unclear. Admittedly, Article 9 of the trilateral investment treaty (paragraph 1) stipulates, "Each Contracting Party shall, in accordance with its laws and regulations, protect intellectual property rights" and "Each Contracting Party shall establish and maintain transparent intellectual property rights regimes." Although this provision had not been included in either the previous Japan-

Korea nor the Japan-China bilateral investment agreement, Foreign Minister Kishida states that the joint effort by Japan and Korea led to the inclusion of this IPR provision.<sup>22</sup> With regard to the provisions of the ISDS, however, METI's brief on the trilateral investment agreement elucidates that Article 9 (paragraph 2) covers exemptions from ISDS,<sup>23</sup> while Yasushi Masaki, Deputy Director-General of the Economic Affairs Bureau of MOFA, states that all breaches of duty qualify for arbitration.<sup>24</sup> Moreover this agreement did not establish common rules for IPR among the three countries, as written in Article 9 (paragraph 2). In short, though provisions for IPR should be seen as owing to Japan's efforts, it is still unclear whether they effectively protect the IPR of Japanese companies.

This treaty is not retroactive, on the basis of Article 27 (paragraph 7). Its effect is expected to enable Japanese companies to claim compensation for lost investments as a result of damage from anti-Japanese movements, based on Article 12, after the treaty comes into force. Masaki stated that investors would be able to submit the issue to international arbitration if property were destroyed by riot or fire.<sup>25</sup> An assessment of the effectiveness of this important provision has to wait until the next incident.

What Japan sought to achieve in the trilateral investment treaty can be summarized as binding China to the rule of law, increasing legal stability, and predictability for Japanese investors as seen in the cases of national treatment, IPR, and ISDS. However, the contents of the treaty reveal that Japan made compromises with China. This is a factor that makes Japan more enthusiastic about TPP. Nevertheless, in spite of political and historical tensions that are not easily resolved, both economic cooperation arrangements have continued to elicit the cooperation of senior officials. Japan's expectations for trilateral cooperation remain positive for maintaining dialogue with its nearest neighbors over their shared economic interests, as a way of improving relations. In fact, in the midst of China and the ROK's vehement criticism of Abe's visit to the Yasukuni Shrine, the three countries' negotiators met to discuss the trilateral FTA in Malaysia on the occasion of RCEP negotiations in January 2014. They agreed that trade negotiations and political issues should be separated, adding that trilateral FTA negotiations would keep advancing,<sup>26</sup> reflecting Japan's approach of separating politics from economics.

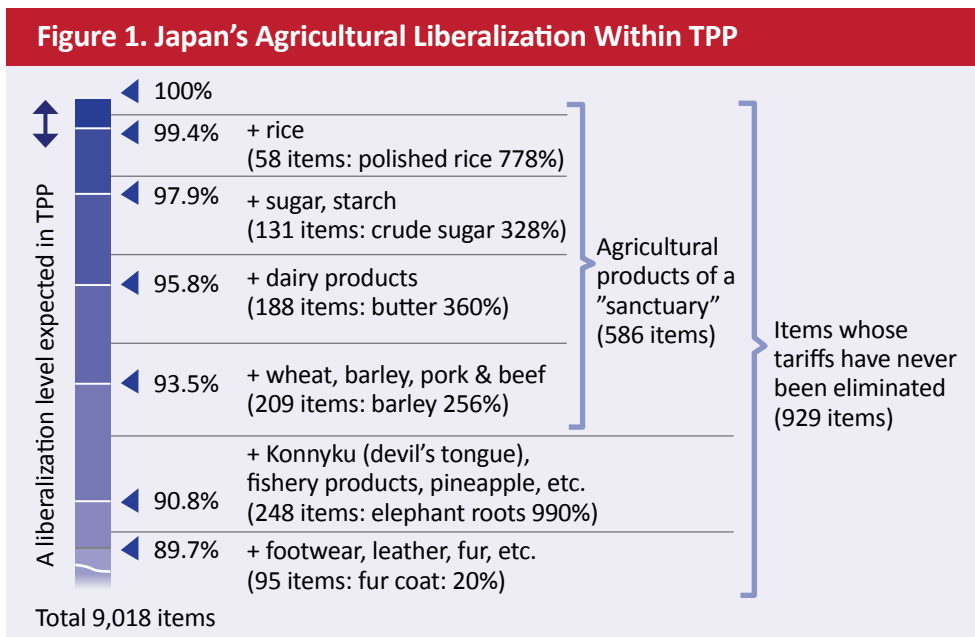
## REGIONAL INTEGRATION AND JAPAN'S AGRICULTURAL LIBERALIZATION CHALLENGE

Agricultural liberalization is the unresolved issue for Japan's further commitment to any regional integration framework or FTA. Japan has established FTAs with ASEAN and seven ASEAN member nations, but given its dominant trade and economic position it has an overwhelming advantage over partner countries in terms of bargaining power. As a result, in the majority of cases Japan has been able to shelve consideration of the elimination of its agricultural tariffs, and it has in return used its economic power to offer benefits in the form of economic cooperation. This pattern enabled Japan to conclude a series of bilateral FTAs that have avoided any promise of agricultural liberalization. Moreover, in FTAs concluded between Japan and ASEAN member nations, overall Japan has a lower percentage of items for which tariffs have been eliminated, despite the other party being a developing country. For this very reason, however, during negotiations over TPP blocs are likely to be formed

between the numerous exporting nations that share a common objective of gaining access to Japan's agricultural markets.

The diagram below indicates the products that Japan has never touched in an FTA that it has signed, and most are agricultural products. Of the 930 items for which tariffs were not eliminated in FTAs Japan has so far concluded, 850 were agricultural, forestry, or fisheries products, including rice. Farmers and the Central Union of Agricultural Cooperatives (known as *Zenchu*), which have worked against FTAs in the past, have been particularly vehement in their stance against TPP as, in principle, it would eliminate all tariffs.<sup>27</sup> Abe, who made a decision on Japan's participation in the wake of his talks with Obama in February 2013, has encountered strong resistance from his own LDP, which became adamant in calling for the complete protection of products categorized as "sanctuary." Some LDP members urge the cabinet to follow the Diet resolution on Japan's participation in the TPP negotiations, which stipulates that "sensitive agriculture, forestry and fisheries products—including rice, wheat and barley, beef and pork, dairy products, sugar and starch crops—are either to be excluded from the negotiations or to be subject to renegotiation in order to maintain sustainable domestic production. Even the gradual elimination of tariffs over a period of more than ten years is unacceptable."<sup>28</sup> LDP Secretary General Ishiba Shigeru promised to protect these five sensitive products from tariff elimination by TPP in the course of the campaign for Upper House elections in July 2013.<sup>29</sup>

In TPP negotiations, nations who share some interest tend to form a coalition to realize it. Japan is being pressured to concede agricultural protection, including the "sanctuary" products, given the liberalization rates of the FTAs signed by TPP members such as the United States, Australia, and New Zealand, which range from 95 to 100 percent. Japan desperately needs farm reform in the process of signing TPP, and Japan is now preparing for eliminating tariffs on almost all fisheries as a part of it.<sup>30</sup>



Source: *Nihon Keisai Shimbum* (September 5, 2013)



Another major agricultural reform the Abe government seeks to implement in preparation for its commitment to the conclusion of TPP concerns *gentan*, curtailing rice production through a reduction in the acreage of rice paddies in exchange for subsidy payments. This system has been in place for more than 40 years to maintain a higher price of rice through limiting the crop. It sacrifices consumers' interests, while stabilizing rice farmers' income, especially for small-scale, part-time farmers who usually work in factories, retail shops, or local governments during the regular work week. This means that the portion contributed by agriculture in their total income is rather small, and that agricultural liberalization, especially in rice, would not deprive them of a primary source of income. In fact, their annual income is slightly, but consistently higher than that of average non-agricultural workers. *Gentan* can thus be regarded as a political tool for politicians to stably receive votes and funds from those part-time farmers at a time of local and national elections. Abe expressed his determination to carry out this agricultural reform in his keynote speech at the Davos Forum,<sup>31</sup> indicating that *gentan* would be abandoned five years from now. This means that the LDP may be able to soothe part-time rice farmers' resentment in the next elections of both the Upper House and Lower House—unlikely to be held for two and a half years—and not running the risk of losing their votes. This illustrates Abe's lukewarm commitment to farm reforms, anticipating the continued existence of the major obstacle to Japan's leadership in the multiple regional integration initiatives.

Given that market access is generally viewed as “the heart and soul of the trade agreement,” as Tim Groser, New Zealand trade minister explains,<sup>32</sup> the stalled bilateral negotiation on market access between Japan and the United States have served as the most serious hurdle for the conclusion of TPP. If this trend continued, Japan's strong resistance to tariff reductions or elimination in five “sanctuary” agricultural products, as well as America's resistance to proposals for the liberalization of the automobile sector, are possible reasons for negotiations bogging down.

To move forward the TPP market access negotiations with the United States, Japan appears to rely on the operational logic of the domino theory. Japan's best interest in this sense was to minimize the level of its agricultural liberalization, especially beef and pork products, for which the United States has strongly demanded to eliminate or substantially reduce tariffs, while gaining a timetable from the United States to lower current levels of tariffs on imports of passenger cars (2.5 percent) and light trucks (25 percent). Japan decided to complete a bilateral FTA with Australia, America's largest competitor over beef in Japan, ahead of the TPP by giving Australia preferential market access to its own beef market as a way for getting concessions from the United States during the bilateral market access negotiations. Under the agreement Japan promised Australia that the 38.5 percent tariff on *beef* from *Australia* would be scaled down to 19.5 percent for frozen and 30.5 percent for fresh meat. This Japanese tactic appeared to be effective as Wendy Cutler, Acting Deputy USTR, acknowledged that an Australia-Japan FTA deal would possibly “put U.S. agricultural exporters at a disadvantage in the Japanese market.”<sup>33</sup> Yet, the U.S.-Japan bilateral deal was not concluded and the joint statement of April 25, 2014 failed to include any sign of a breakthrough in the bilateral negotiations for TPP, despite the two ministers in charge of the trade negotiations unprecedentedly spending more than 40 hours together over a few weeks. A reason behind the failure of the domino logic is Japan's persistent hesitation

towards agricultural liberalization. *Japan's promised* tariff reduction on frozen *beef* is limited to 19.5 percent with gradual implementation over 18 years. That is not considered sufficient for American negotiators; a more substantial tariff cut under a shorter time frame was presumably needed.

The delay in TPP negotiations has also influenced the domino effect in regional integration in East Asia and the Pacific. Making two significant concessions to Japan with a view to promoting its preferred regional integration frameworks after finding potential harm to its trade strategy caused by Japan's participation in TPP, China is now taking a "see how it goes" approach due to the stalled TPP negotiations.<sup>34</sup> This may signify China's disinclination toward a regional integration framework involving Japan such as CJK FTA, consequently exerting a negative impact on Japan's "golden opportunity" in its regional integration strategy. Since China also finds it attractive to gain preferential market access to Japan's agricultural sector, one of the world's largest agricultural import markets, Japan's liberalization in this sector is a decisive step in moving forward the negotiations on both TPP and CJK FTA.

## CONCLUSION

After reviewing Japan's interest in and approach to TPP, RCEP, and CJK, this article concludes that they offer different potential benefits, given Japan's relatively unique economic structure in East Asia. Japan's markets and exports differ substantially from those of China and other countries of East Asia. It continues to specialize in high added-value commodity exports, its international-oriented business sectors have expressed a great deal of interest in the liberalization of services and investment in the region, its machinery and automobile companies have extended their production networks broadly across East Asia and the Pacific, and the strong competitiveness of its manufacturing products, as demonstrated by an average tariff rate of less than 3 percent at home, illustrates the openness of domestic markets. Given the trade and market features that Japan enjoys, the cost of non-participation in TPP would be high, failing to secure maximum trade and investment benefits as more countries sign on to form a "critical mass." Liberalization of the service and investment sectors, for example, is quite unlikely to make significant progress under RCEP and CJK FTA, partly because China and developing nations of ASEAN strongly resist this, which would require transparency about business activities in state-owned companies.

Japan has a significant volume of trade with major Asian countries such as China, India, Thailand, and Indonesia, which do not currently participate in TPP (South Korea announced its interest in joining in December 2013), and many Japanese companies have set up a wide range of production networks involving these countries. These non-TPP members in Asia tend to protect some of their key industries (e.g., China imposes a 25 percent tariff on automobiles); so progress in RCEP or CJK FTA is also important as a tool to open these key markets to Japanese exports. Accordingly, this complex profusion of regional integration initiatives presents a "golden opportunity" for the Japanese economy. The best scenario is obviously to conclude all of these agreements, increasing the coverage ratio of Japan's overall trade by regional integration partners, including the EU, from approximately 20 to 85 percent. This figure would surpass that of Korea. In summary, RCEP provides Japan a market expansion traditional mechanism through eliminating

higher tariffs imposed by its larger trading partners such as China, India, and Indonesia, which more heavily protect their markets, while TPP offers a rule-making, cutting-edge mechanism through establishing more developed-nation-oriented trade and investment rules. CJK has a distinctive function for Japan due to its frustrated relations with Korea and China over history and territory issues; a political management mechanism through enhancing ways for increasing mutual economic interdependence.

Yet, agricultural liberalization remains the largest barrier to Japan's leadership role in any of these regional integration frameworks, and its protective position over rice, sugar, pork/beef or dairy products, together with America's automobiles, have caused the delay in the TPPs market access negotiations. If Abe, who enjoys relatively high public support and does not need to hold national-level elections over the next few years, cannot carry out the elimination of tariffs on some, not all, agricultural products categorized as "sanctuary," there is little hope for Japan's regional integration policy.

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# Korean Bridge: Balancing Asian Economic Regionalism Between the United States and China

Jin Kyo Suh

The debate on TPP versus RCEP has been widely recognized as a struggle between the United States and China for expanding their influence in the Asia-Pacific region, and it is now commonplace for scholars to discuss the rivalry between the two agreements.<sup>1</sup> Both the TPP and RCEP agreements could invigorate the sluggish Asia-Pacific economy by promoting trade liberalization and economic integration; however, the story is not so simple because they have been recognized as being a political tool as well as economic drivers. An important change occurred on March 15, 2013 when Prime Minister Abe Shinzo announced that Japan would formally seek to join the negotiations to establish TPP, in which the United States leads. Japan became the 12<sup>th</sup> member of the negotiations at the 18<sup>th</sup> round on July 2013 and now leads the TPP negotiations with the United States. From its perspective, Japan's participation in TPP might be the best option for revitalizing its economy and restoring its growth.<sup>2</sup> At the same time, it caused the equilibrium between the competing TPP and RCEP to shift toward TPP.

TPP aims to be a 21<sup>st</sup> century trade agreement that sets the rules for trade and investment in the Asia-Pacific region going forward. Achieving this goal will require other major economies in the region to join TPP with the intention of ultimately becoming a FTA of the Asia-Pacific (FTAAP). Japan's participation in TPP will give added momentum towards this goal. As the second largest economy in Asia and the third largest economy in the world, Japan's participation would be pivotal to enhancing the credibility and viability of TPP as a regional FTA. With Japan, TPP covers roughly 40 percent of global GDP as compared to 30 percent by RCEP countries. Furthermore, Japan's entry into the TPP talks gave further impetus to other countries. Korea expressed its interest in joining the ongoing negotiations for TPP late last year. The Philippines and Thailand are watching the TPP negotiations with an eye to joining. The TPP with Japan creates the impetus for China, Korea, and ASEAN to reconsider Asia-Pacific economic regionalism and to modify their regional integration.

ASEAN is on the ropes and will again worry about the possibility of marginalization in the process of Asian economic integration. The sudden rise of RCEP is, in fact, closely related to the rise of the U.S.-led TPP, including the China, Japan, and Korea (CJK) FTA. ASEAN, a group comprised of relatively small countries, entered into the ASEAN FTA (AFTA) in 1992 and began a step-by-step liberalization of trade. RCEP has built an ASEAN+1 FTA network throughout greater Asia with ASEAN occupying the pivotal position. Most likely ASEAN was able to take the helm of the region because RCEP was put forward in an effort to avoid conflict and rivalry between China and Japan and because stable economic growth makes it an attractive candidate.

From 2010, however, ASEAN was worried that the U.S.-led TPP could weaken ties in ASEAN and might marginalize the association. Four of the ASEAN 10 (Singapore, Brunei, Vietnam, and Malaysia) have already joined the TPP talks, causing concern that the association could split into two: TPP-ASEAN and non-TPP ASEAN. The option of ASEAN joining the TPP as a region would be possible, but those countries whose level of development are lagging, such as Cambodia, Laos, and Myanmar, could not accept high-quality market access with few exemptions and extensive regulatory alignment that TPP pursues.



From 2011, TPP was the leading trade policy initiative of the Obama administration. As a core component of efforts to rebalance toward the Asia-Pacific region, TPP negotiations were accelerated. ASEAN also hastened RCEP negotiations with the goal of consolidating the internal solidarity of the association. At first, China was wary of RCEP, taking a strong stance in favor of economic integration only within East Asia,<sup>3</sup> while seeking to prevent direct conflict with the United States by having ASEAN take the lead. Subsequently, China sought to help ASEAN accelerate the progress of RCEP with broader scope, but not with the United States. Since Japan showed strong leanings towards TPP from that time, China shared ASEAN's concerns about a centrifugal force arising to split asunder the economic integration of East Asia. In addition to the U.S.-led TPP, the fact that preparations are underway for negotiations for a CJK FTA has caused ASEAN to move up its proposal for forming RCEP. Because of such concern, ASEAN has more vigorously promoted RCEP in an effort to maintain its centrality in regional economic integration by not falling behind the momentum elsewhere.

ASEAN's efforts have apparently largely been for naught. The TPP alliance was expanded and even strengthened by Japan's participation. The CJK FTA negotiations, which remained elusive until the end of 2012, were launched and even finished their third formal meeting in November 2013. Now there is doubt that ASEAN will preserve its centrality by shepherding RCEP to a successful conclusion. Taking into account these new circumstances, it is time for ASEAN to search for ways to preserve its centrality in economic integration and to discuss its troubles frankly with large economies in the region as well as ASEAN member countries.

China is presumably much less comfortable with Japan's participation in TPP, which it has regarded as the U.S. effort to encircle it. It is obvious that the current TPP contains many provisions that China would find unacceptable, at least in the near future, such as state-owned enterprises (SOE) regulations and increased intellectual property rights (IPR) protection. Although China's attitude towards TPP has softened in recent months, with some officials and analysts recently arguing that China should participate, this is unlikely in the near future. Therefore, China has responded by forging ahead with RCEP and its own FTA negotiations, including the CJK FTA. Development of RCEP could receive strong backing from both China and ASEAN; however, prospects for the CJK FTA have turned darker.

The CJK FTA definitely has large benefits for the three Northeast Asian countries and significant implications for global multilateral trade. It can also be regarded as a stepping-stone for successful conclusion of RCEP negotiations; however, there are significant hurdles that make its expeditious completion or even bilateral FTAs between Japan and China or between Japan and Korea extremely difficult. In particular, historical issues and unsettled territorial disputes continue to cause uncertainty in the future of CJK FTA negotiations.<sup>4</sup>

Korea has dealt with the delicate balance between the United States and China. It signed the KORUS FTA and is now negotiating a bilateral FTA with China. Moreover, Korea is playing a major role in RCEP negotiations. With the KORUS FTA, and agreements with other TPP partners (Australia, Canada, Chile, Peru, Singapore, and ASEAN) already in place,<sup>5</sup> Korea was confident that it could join TPP at a later date. However, Japan's recent entry changes its calculus. Entry into TPP would give Japan a stronger bargaining position in its other

outstanding trade negotiations, such as RCEP and the accord with China and South Korea. In fact, Japan is becoming a linchpin in the overall process of region-wide FTA formations, which Korea had hoped to become after the KORUS FTA.

In summation, in regional context, there appears to be an economic and geopolitical contest between TPP and RCEP. The CJK FTA is also inextricably connected to the region's strategic environment and the alternative FTAs of TPP and RCEP. With those complicated competing negotiations being pressed by the United States, China, Japan, and ASEAN, how these agreements evolve over time will greatly affect the structure of the Asia-Pacific economy in the years ahead, and even the political relationship between the United States and China. Because of Korea's wide-ranging FTA networks, its decisions on economic regionalism will be an important signal of its vision for the future of Asia and the leadership it can exert. This chapter examines its options and the various strategies that Korea could employ to balance the pressures from China and the United States, while gaining the most economic benefit from the potential regional integration. With this in mind, the following sections focus on Korean thinking about both TPP and RCEP in terms of global trade flows and geopolitical impact and consider Korean views of what is the right balance in Asia-Pacific economic regionalism between the two great powers.

## KOREA'S VIEWS ON TPP AND RCEP

### TPP and Korea

**(1) TPP as a New Global Standard for Future International Trade.** TPP clearly has potential to be a new global standard for international trade. With 29 chapters under negotiation, TPP partners seek new disciplines on certain activities not heretofore addressed in both FTAs and the WTO. For example, TPP deals with new issues such as regulatory coherence, supply chain competitiveness, and small-and medium-sized enterprises. This is a major reason why TPP is called a 21<sup>st</sup> century regional FTA. If concluded as envisioned, it could serve as a template for a future global trade pact among WTO as well as APEC members.

Currently ranking as the 7<sup>th</sup> largest exporter and 12<sup>th</sup> largest economy in the world, Korea cannot help having great interest in the new rules and standards under negotiation by current TPP partners.<sup>6</sup> TPP will seriously affect Korea's exports to 12 TPP member countries as well as to non-TPP countries. Furthermore, TPP could influence the shape of Korea's trade policy for the foreseeable future. Korea has a strong incentive to participate in the TPP negotiations as soon as possible in order to put its own interests into the rule-making process on 21<sup>st</sup> century new trade issues before the negotiations are finalized. Last December, Wendy Cutler, acting Deputy U.S. Trade Representative, said it would be very difficult for any country, including Korea, to join the ongoing TPP negotiations, noting that the TPP talks are already in the end game. However, given the substantive disagreements among TPP negotiators on market access, intellectual property protection, and state-owned enterprises, it is conceivable that the negotiations could extend into 2015.

Since Korea is already well prepared to embrace the rigorous standards of TPP, as they closely reflect provisions negotiated in the KORUS FTA and Korea-EU FTA, the adjustment costs of membership are estimated as not very onerous. For instance, the KORUS FTA goes

further than the WTO in a range of areas, including intellectual property rules, services, and non-tariff barriers such as standards. Additionally, it addresses so-called “WTO-plus” issues by including commitments in areas such as investment access and protection, trade facilitation, competition, and environmental and labor policy.

**(2) TPP as a Mechanism for De Facto Isolation of China in East Asia.** Korea’s entrance into TPP could cause serious imbalance in the two competing region-wide FTAs, as noted above. Although the TPP seeks to be a “living agreement”—meaning that other countries can join at any time and other areas of trade can be added to the agreement in the future—the high standards are thought to be too big a barrier for China to overcome in the foreseeable future. While TPP does not intend to marginalize China in East Asia, it is also true that the content of TPP is beyond China’s acceptance limit.

Chinese leaders recognize that a series of policy changes are needed if they are to sustain economic growth, ensure social stability, and restore the tarnished legitimacy of the communist party. However, they fully understand that rapid market reform is not a feasible pathway to this end. China cannot participate in TPP negotiations, at least in the near future, because it could result in both rapid and unsettling reform of its fundamental economic and social structure. Therefore, from China’s point of view, the “living agreement” idea can be seen as a purely rhetorical device. China may believe that Japan’s successful entry into the TPP negotiations means that the United States has taken a step forward in encircling it. In this situation, a decision by Korea to join TPP could be absolutely undesirable for China and could provoke a serious imbalance in two competing mega region-wide FTAs: TPP and RCEP. Already suffering from diminishing competitiveness, China is keen to avoid any further hits to its trade position, which it would view through the lens of geopolitics as well as economics. The impact could be dangerous for regional stability.

**Table 1. TPP versus RCEP: GDP and Trade (Unit: Billion US Dollars, %)**

	TPP			RCEP
	TPP11	TPP12	TPP13	
GDP	22,824	27,831	29,029	20,983
	(31.1)	(37.9)	(39.5)	(28.6)
Trade	7,858	9,543	10,610	13,160
	(21.2)	(25.8)	(28.7)	(35.5)

*Note: TPP11: Japan is excluded. TPP12: TPP11 + Japan. TPP13: TPP12 + Korea. The figure in parenthesis is both the GDP and trade share of each agreement, compared to world GDP and world trade. GDP is based on the 2013 data, and trade is based on 2012 data.*

*Source: IMF, World Economic Outlook Database (October 2013); WTO, World Trade Statistics 2013*

China is the most important trading partner of Korea. The bilateral trade agreement with China covers a quarter of Korea's exports. The trade surplus with China amounted to more than \$53 billion in 2012, which is almost twice Korea's total trade surplus, similarly calculated in 2013. In addition, China has influence on North Korea's decision-making, which directly relates to the national security of South Korea. These significant factors cannot be ignored.

**Table 2. Korea's Merchandise Trade with China (2012-13)**

	Total (A)		With China (B)		(B/A)	
	2012	2013	2012	2013	2012	2013
Export	547,870	559,649	134,323	145,837	0.245	0.261
Import	519,584	515,561	80,785	83,037	0.155	0.161
Balance	28,285	44,088	53,538	62,799	1.893	1.424

*Source: KITA (Korea International Trade Association), Trade Statistics*

As a middle power in this region, Korea needs to pursue a balanced position in the process of Asia-Pacific economic integration, not only economically but also politically. In other words, Korea should prepare for entrance into the TPP negotiations but at the same time should guarantee that its participation in TPP is not harmful to the interests of China. Early conclusion of the bilateral FTA negotiations with China is one way to provide such reassurance. Exerting maximum effort for RCEP negotiations to make rapid progress is another. Both the bilateral FTA with China and RCEP could serve as a kind of insurance, preparing for the non-participation of Korea in TPP, should it be found that the cost of membership would be excessive.

**(3) TPP as Requesting Expensive Entry Fees for Korea.** Although the cost of TPP membership is estimated as not onerous, that estimation does not take into full account market access for goods. In its bilateral consultations with TPP partners, Korea may liberalize its sensitive items (e.g., rice or certain manufacturing sectors such as vehicles) further at the request of each of the current TPP countries.<sup>7</sup> This could impose costs many are unwilling to bear. Korea has finished the first round of bilateral consultations with current TPP members. It is said that Korea took a strong defensive position over manufactured goods in the negotiations with Japan.<sup>8</sup>

Currently Korean farmers strongly oppose its participation in TPP because they recognize TPP to be the second KORUS FTA and the TPP pursues much more ambitious liberalization targets. They seem to believe that the United States could demand the full liberalization of the Korean rice market, which is excluded in the market access of KORUS FTA. Many manufacturing enterprises think that TPP is a de facto bilateral FTA with Japan and are deeply concerned that their enterprises would be adversely affected by Japanese competition. Thus, in return for entry into the TPP talks, Korea may have to pay a significant price such as full liberalization of the agricultural market or immediate

elimination of tariffs on Japanese vehicles.<sup>9</sup> Such a big cost, although it may be smaller than the long-run gains, would be one of the major hurdles for Korea to enter into the gate of TPP. These domestic constraints have weighed heavily on the decision of whether to join TPP.

Table 3. Korea's Merchandise Trade with Japan (Unit: Billion US Dollars, %)		2000	2005	2010	2013
Total	Export	20.5	24.0	28.2	34.5
	Import	31.8	48.4	64.3	60.0
	Balance (A)	-11.4	-24.4	-36.1	-25.3
Manufactured products	Export	18.6	22.6	26.3	32.7
	Import	31.4	48.0	63.7	59.6
	Balance (B)	-12.8	-25.4	-37.4	-26.9
Machine & Vehicles	Export	8.4	8.4	9.5	10.3
	Import	17.3	21.3	24.5	21.9
	Balance (C)	-8.9	-12.9	-15.0	-11.6
B/A		1.13	1.04	1.04	1.07
C/B		0.70	0.51	0.40	0.43

Source: KITA (Korea International Trade Association), Trade Statistics ([www.kita.net](http://www.kita.net))

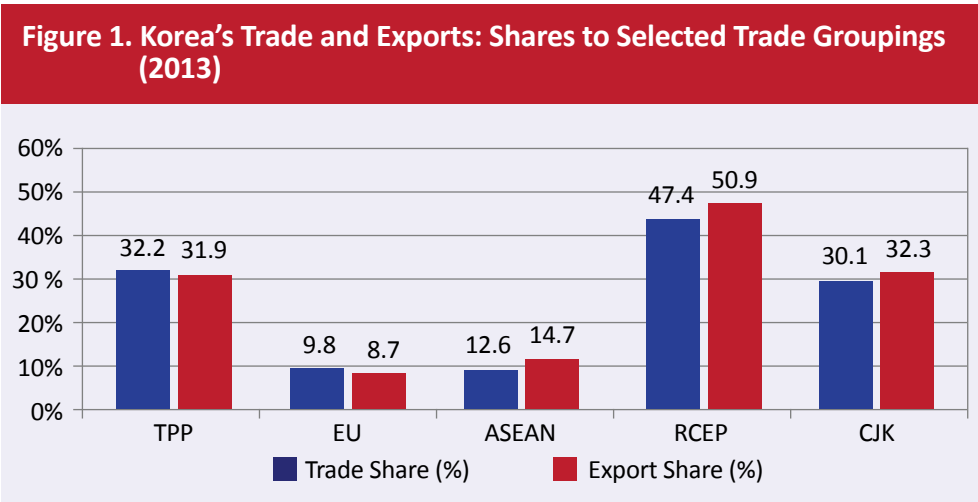
**(4) Uncertain Expected Gains from TPP.** Korea is expected to reap significant long-term benefits from joining TPP.<sup>10</sup> Furthermore, the benefits of membership are manifold: greater bargaining power in ongoing negotiations with China and Japan to tackle non-tariff barriers, the rationalization of its FTA “noodle bowl” of multiple trade rules, and the consolidation of a forward-leaning alliance with the United States. However, there exist different views on how much Korea would really gain. First, the KORUS FTA and other separate free trade pacts with TPP countries will reduce the additional gains from the TPP pact. Second, although members have agreed to pursue a single set of TPP rules of origin, they are pursuing different approaches to developing a TPP tariff schedule. The United States has maintained that it was negotiating market access bilaterally and only with the TPP partners with which it did not have an FTA. Other participants have sought to negotiate plurilateral market access schedules. Thus, without firm harmonization of TPP rules of origin, the TPP may end up undermining the global trade system by adding more “noodles” to the bowl. Third, it is unclear exactly how TPP will address supply chains. China is, in fact, at the center of Asia’s trade growth and is a key link in global supply chains in Asia. The trade share of most Asian countries with China is higher than 10 percent. Even the U.S. import share from China is more than 19 percent. Therefore, the Asian supply chain without China would seem like an agreement with a big hole.

Table 4. Merchandise Trade of Major Asia Pacific Countries with China (Unit: %)		
	Export Share (to China)	Import Share (from China)
Korea	26.1	16.1
Japan	18.1	21.7
ASEAN	11.4	14.8
Australia	29.5	18.2
New Zealand	15.0	16.4
India	5.0	11.0
United Sates	7.7	19.2

*Note: The share is the percentage of exports (imports) going to (from) China to total exports (imports) of a country or region. Figures of ASEAN, Australia, New Zealand, and India are 2012 statistics and other figures are 2013 statistics.*

*Source: KITA (Korea International Trade Association), Trade Statistics, MOF (Ministry of Finance), Trade Statistics of Japan, USDA, US Census Bureau, IMF, Direction of Trade Statistics*

Petri, Plummer, and Zhai estimated that RCEP would yield income gains by the year 2025 equivalent to 4.1 percent of GDP, which is almost two times higher than that of TPP.<sup>11</sup> Some Korean scholars argue that Korea should be prioritizing the RCEP negotiations, including CJK trilateral FTA negotiations. Korea’s exports to the RCEP economies were \$285 billion in 2013, which is more than 50 percent of its total exports.



*Note: Trade means the sum of exports and imports*

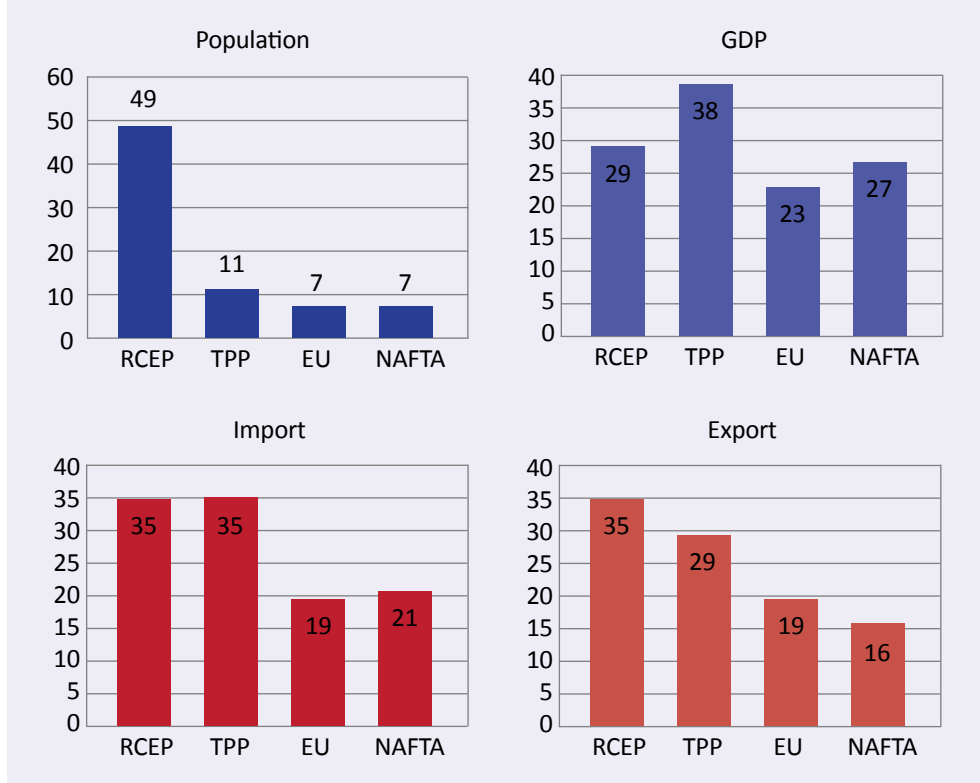
*Source: KITA (Korea International Trade Association), Trade Statistics*



## RCEP AND KOREA

**(1) RCEP as a Strong Rival of TPP in Regional Integration in Asia.** RCEP includes more than 3.4 billion people, has a combined GDP of about \$21 trillion, and accounts for about 35 percent of world trade. If concluded successfully, RCEP would create the world's largest trading bloc and has major implications for not only the Asian economy but also the world economy. In particular, it would be a powerful vehicle to support the spread of global production networks and reduce the inefficiencies of multiple Asian FTAs that exist presently.

**Figure 2. RCEP's Share of the World: Population, GDP, and Trade (unit %)**



*Note: Intra-EU trade (both imports and exports) is excluded*

*Source: IMF, World Economic Outlook Database (Oct. 2013); WTO, World Trade Statistics 2013*

It is often said that the RCEP is less ambitious than TPP, because of the “flexibility clause” built into its negotiating principles.<sup>12</sup> However, flexibility is RCEP's strength, allowing common objectives to be pursued over different paths and the interests of the less-developed members to be met. An important characteristic of Asian societies is their diversity. Cross-cultural diversity adds to the exotic nature of Asia as a gigantic melting pot of diverse

cultures. Thus, flexibility is an essential factor for allowing Asian countries to integrate. Because of this, RCEP could be superior to TPP in regional economic integration.<sup>13</sup> The level of market access in RCEP could be lower than that in TPP, but RCEP could embrace more economies. Thus, RCEP, if completed successfully, can be insurance to Korea and China, including other ASEAN states outside TPP.

**(2) RCEP Needs Strong Leadership Based on ASEAN Centrality.** Flexibility could be a benefit or a bane for RCEP. While it could help break deadlocks and find compromises among disparate national interests, it could also limit change or curtail progress in achieving greater liberalization. Unless there is enough political will to close potential loopholes disguised as “flexibility” and pursue reforms deeper than those ever before attempted, RCEP’s future as a consolidated bloc remains uncertain. Strong leadership is indispensable to concluding the negotiations successfully.

Leadership should be based on ASEAN centrality. China and Japan might not trust each other, but ASEAN is believed to be impartial. In fact, Japan has been searching for a way to manage the rise of China, largely through its relationship with the United States. ASEAN fears China’s military threat on the issue of the South China Sea, too. ASEAN knows that being too close to China or the United States is harmful to its unity. It can retain centrality by using the “ASEAN Way” of consultation and consensus to accommodate all the voices and needs of its members. In this respect, Korea should play the key role of regional mediator between China and ASEAN.

**(3) RCEP as a Tool for Managing the Rise of China.** ASEAN is concerned that China will eventually dominate East Asia through a China-led East Asia Community. Some countries, especially Myanmar and Vietnam, have actively engaged in strategic balancing between China and the United States. They seek more robust economic and strategic relationships with the United States to hedge against China’s threat. Thus, RCEP based on “ASEAN centrality” can be used to check the rise of China. ASEAN has long been considered neutral—it is not dominated by a great power. Fear of such domination may prompt ASEAN to strengthen itself and maintain unity, safeguard the consensus principle, and engage more carefully with regional powers.

## CONCLUSION: DUAL TRACK APPROACH

Initially a trade pact envisaged by Brunei, Chile, New Zealand, and Singapore, TPP was transformed in 2008 when the United States expressed its interest. It has expanded to 12 members. In particular, Japan’s entry into the negotiations brings a critical mass to a deal that, if completed, would cover countries that account for two-fifths of global output. The TPP agreement is ambitious in terms of not only its size, but also the scope and scale of its liberalization. If the United States also concluded a FTA agreement with the EU, it would have signed deals with countries accounting for two-thirds of global output. TPP, in other words, could be part of a grand strategy to conclude an only slightly less ambitious version of the Doha round by other means.

RCEP starts with flexibility in its guiding principles, allowing differential treatment for developing countries while still aiming for a high-standard agreement. While it would

expand ASEAN's role in coordinating regional free trade negotiations, RCEP could help regionalize the sophisticated global production networks that make Asia the world's factory. It would also reduce the overlap among Asian FTAs, lest Asia becomes a confusing "noodle bowl" of multiple trade rules.

TPP and RCEP may end up either providing ballast to the global trading system—and bringing some coherence to the many regional FTAs—or undermining it, by adding more "noodles" to the bowl. To achieve the first scenario, the agreements need to be complementary and outward looking, i.e., they should minimize discrimination towards non-members and be open to adding new members. The worst-case scenario is for these agreements to become competing, exclusive blocs with very little overlap in membership. It is already clear that it will be difficult for China to join TPP given the high hurdles to membership, and the U.S. Congress will not easily facilitate U.S. membership in RCEP.

Many analysts, noting the absence of China, regard TPP as a geopolitical club masquerading as a free-trade one. Until recently, some Chinese leaders described TPP as a plot designed to contain China's rise. In this situation it is not easy for Korea to decide to join TPP; however, it does not want to be excluded in the rule-setting process for future global trade norms. This leads to a dual track approach. On the one hand, Korea pursues entry into TPP. On the other, it makes the utmost effort to conclude RCEP by 2015, based on the completion of a bilateral FTA with China. This is almost the same idea as that of a new FTA roadmap in June 2013, in which Korea plays the role of a linchpin between the integrated market of East Asia centered around China and the pan-Pacific market led by the United States. The synergy effects of acting as a "bridge" in these mega trade negotiations could be substantial. This could play out in three steps.

**Step 1-A: Early Conclusion of the Korea-China FTA.** This could be a crucial precondition for the successful conclusion of the RCEP talks as well as the CJK FTA negotiations. It would also strengthen Korea's bargaining leverage when it starts to consult with existing TPP partners on joining the negotiations, while serving as a kind of insurance, preparing for non-participation in TPP, should the costs prove to be excessive. Since the KORUS FTA has already come into effect, the completion of Korea-China FTA talks has added significance for Korea.

**Step 1-B: Start of Bilateral Consultations with TPP Members.** Korea has already expressed its interest in joining TPP—its application for membership is really a matter of time. Then, the faster it joins TPP, the lower the entrance fees. At present it is proceeding with bilateral consultations with the current TPP countries simultaneously. A final decision on entry would be subject to the results of the bilateral consultations as well as the progress of the bilateral FTA negotiations with China. Korea has to keep open the possibility that it will not join TPP after all. If the entry costs are small enough for Korea to bear, then Korea should finish the China-Korea FTA negotiations quickly and, at the same time, enter into the TPP negotiations.

**Step 2: Acceleration of the CJK FTA.** This step is a natural result of step 1. In addition, the CJK FTA could be a stepping-stone to reach a successful conclusion in RCEP negotiations. Korea needs to accelerate the trilateral negotiations in a balanced manner. Agreement on

the Korea-China FTA could be a useful template for the CJK FTA talks. If Japan opened its agricultural market in TPP, this could also be advantageous for accelerating negotiations on the CJK FTA, as agricultural products are considered a difficult problem for the three states. However, the tension between China and Japan would make the CJK FTA difficult in the foreseeable future. Thus, Korea has to exert utmost effort for progress in the CJK FTA, at the same time leaving room to bypass it in favor of the reduced form of RCEP directly without the CJK FTA.

**Step 3: Creation of a Reduced Form of the RCEP.** RCEP is scheduled to conclude by the end of 2015; however, it will not be easy. Large countries may be reluctant to respect the central role of ASEAN. The flexibility clause could help break deadlocks, but could also curtail progress in achieving greater liberalization. In addition, varying internal policies of countries could prove to be difficult to harmonize and consolidate under RCEP. RCEP could still be put at risk because of tensions between its members, especially China and Japan. The South China Sea dispute involving China and several ASEAN countries also could reverberate in this manner.

In this situation, a more productive strategy is to see a streamlined trade agreement as one of the several steps that will be needed for an RCEP that embraces a more comprehensive program of regional economic integration and development. RCEP participants should not have to wait for a single trade liberalization by all participants and for agreement on all new rules before taking up the other opportunities for beneficial economic integration. RCEP can seek to achieve a significant initial down payment on trade liberalization and lock in progress towards ambitious end-point goals. The meaning of “reduced form” of RCEP can be either a reduced number of participants or a reduced context of market liberalization.

Korea needs to attempt to handpick the best features of existing Asian FTAs and use them as a basis for further negotiations for RCEP. Like early-harvest Bali packages in the Doha Round, a reduced form of RCEP can also be a useful interim solution for the final agreement. In this Asian track, Korea could play a balanced role among China, Japan, and ASEAN nations. Furthermore, based on the FTAs with China and the United States, it could assume a major role in linking RCEP with the U.S.-led TPP. These steps are not very different from a new roadmap for trade policy announced by the Park Geun-hye administration, which puts special emphasis on Korea’s linchpin role in regional economic integration in East Asia through a new FTA with China and the already signed agreement with the United States.

## ENDNOTES

1. This article is revised from, “Korea’s Perspectives on the TPP,” which was presented at the Conference on the Trans-Pacific Partnership and Taiwan’s Future Development Strategy at Stanford University, October 11-12, 2013. I am grateful to John Dyck of ERS/USDA for valuable comments.
2. According to many estimates, Japan’s economy would be about 2.5 percent larger in 2015 with TPP than it would be without TPP.
3. In fact, China proposed the EAFTA (East Asia FTA), which is based on ASEAN+3, and actively promotes the integration of Asia on this basis, not paying much attention to ASEAN’s central position as the driver of Asian reorganization.
4. The tension between Japan and China over the Senkaku/Diaoyu Islands, including the tension between Korea and Japan over the Dokdo/Takeshima Islands would make the CJK difficult to achieve in any case.

5. Recently Korea concluded bilateral FTA negotiations with Canada.
6. In this respect, other major developing countries, such as China, Brazil, and India, may have the same view as Korea.
7. Rice has been excluded in every previous FTA agreement that Korea concluded.
8. The lack of market opening in agricultural goods and pervasive NTBs in Japan was considered to be the reason for the Korea-Japan FTA negotiations' breakdown. At the same time, Korea's concerns with an increase in the trade deficit from trade with Japan and the fear of manufacturing competition, especially for small and medium sized enterprises, are other major reasons.
9. In past bilateral FTA talks, Japan requested the immediate elimination of Korean barriers to manufactured goods as well as some exceptions or other protective measures for Japanese agricultural goods.
10. Petri, Peter A., Michael G. Plummer, Fan Zhai. "The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment," *Policy Analyses in International Economics* 98 (Washington: Peterson Institute for Economics, 2012).
11. The larger gains from RCEP reflect the opening of China, with which there is no preexisting FTA, and the benefits of eliminating the larger external barriers of many Asian countries.
12. The flexibility clauses said, "RCEP will include appropriate forms of flexibility including provision for special and differential treatment, plus additional flexibility to the least-developed ASEAN Member States."
13. In this respect, RCEP member economies need to consider the expansion of RCEP to include other economies such as Taiwan.

# China's Choice: To Lead or to Follow on Asian Economic Integration

Zhang Xiaotong



For many years, the major trading countries coexisted comfortably under a multilateral trading system. Major trade liberalizations were agreed upon multilaterally. In most cases, trade disputes were resolved peacefully under the WTO dispute settlement system. The industrialized economies even reached a gentlemen's agreement that no bilateral FTA should be reached among them at the expense of the multilateral route of trade liberalization. All this is about to end. Trading nations are now forging free trade alliances on their own, fragmenting the world trading system and making trade diversions prevalent. Every country is feeling less secure and going for more FTAs. This situation might give rise to a "warring states" scenario (as in ancient China), which could replace the "Congress of Vienna's system of international trade." China is now accelerating the pace of negotiating FTAs, in particular in Asia, largely in response to developments in the negotiations of the TPP, TTIP, and other regional initiatives for economic integration. This chapter discusses the internal and external contexts that China faces, its responses so far, and its possible future behavior, with a focus on the steps it is taking in Asian economic integration.

## CONTEXT

We are probably now in a period of post-multilateralism, or of weak multilateralism. The Pax Americana, which was secured first by American hegemony and later by institutions such as GATT/WTO, is largely gone. The rise of BRICS and the relative decline of the United States and the EU, largely due to the global financial crisis and the Euro debt crisis, have changed the balance of power of the WTO system. The 2003 Cancun WTO Ministerial Conference started to witness the emergence of a new negotiating group consisting of India, Brazil, China, and other developing countries, at loggerheads with the developed economies. One negotiation after another failed, and one deadline after another was missed. The Doha Round was frequently in crisis. Fundamentally, the changed relationship in relative power between a large developing country group and the U.S.-EU-led developed economies has made the existing WTO negotiating mechanism and even the negotiating agenda anachronistic. The United States and the EU finally decided to withdraw from the multilateral negotiating table and move to the regional stage. The Asia-Pacific is obviously the ideal choice since it represents the most vibrant part of today's world economy.

For the United States, it is a strategic withdrawal from multilateralism, which is rooted in its traditional instrumentalism vis-à-vis multilateralism.<sup>1</sup> The U.S. strategic shift from multilateralism to bilateralism/regionalism was equally driven by its geostrategic interests. The Asia-Pacific region is equally important for economic and security objectives. As President Obama made clear, he is a Pacific president. For the EU, the shift is mainly driven by geo-economic interests, as the Asia-Pacific region is an essential part of the global supply chain for European companies.

The U.S. pivot to Asia, and the EU's "looking-East" have caught China by surprise. For a decade, it had been integrating with East Asia through two vehicles—the China-ASEAN FTA and the so-called "10+3" framework, namely ASEAN plus China, Japan, and South Korea. If we decide that the United States had to withdraw from the multilateral front due to the decline of its relative strength and its lack of capacity for providing global public goods, the United States still had sufficient strengths and intellectual leadership to launch an Asia-

Pacific “offensive,” matched by the EU’s looking-east strategy. Slowly, China has started to respond, but it remains indecisive, hesitating between multilateralism and bilateralism. It seems that China has yet to decide whether to fill the vacuum left by the U.S. strategic withdrawal from the multilateral frontier. In the Asia-Pacific region, China seems equally uncertain about which path it should take: 10+3, RCEP, APEC, or TPP. China might eventually use all of them, but it is still an open question which path should be prioritized given China’s limited resources and capacity. The following three sections discuss the implications of TPP, TTIP, and EU-Japan FTAs for China, mainly from the perspective of economics.

## THE IMPLICATIONS OF TPP FOR CHINA

In many ways, China’s Asia-Pacific strategy was a response to the overall context of the U.S. pivot towards Asia and the U.S. discovery of TPP as a geostrategic vehicle for reasserting its influence in the Asia-Pacific. Here, we focus our analysis on TPP’s economic and rules-setting impact on China. First, the completion of TPP would have a significant negative impact on China’s economy. Petri’s study shows that the presence of the TPP would have reduced China’s GDP by \$1 billion in 2014, as much as \$28 billion by 2020, and an even larger \$47 billion by 2025, ultimately lowering China’s GDP by roughly 0.3 percent. Such a negative impact mainly results from the trade diversion effects it causes. By 2025, those effects would lead to a loss of 1.2 percent of China’s exports, equivalent to \$57 billion.<sup>2</sup>

Second, TPP might have some positive effects on China since it is linked to China’s new reform and opening-up agenda. The 3<sup>rd</sup> Plenary Session of the 18<sup>th</sup> Congress of the Chinese Communist Party laid out a reform blueprint, prioritizing the role of the market, calling for SOE reform, more competition, fewer monopolies, and equal treatment of SOEs and privately-owned enterprises. Labor rights, environmental standards, and intellectual property protection are equally put onto the reform agenda. Taking services and investment rules as an example, TPP adopts the pre-establishment national treatment and negative list approach, as China is now doing in the process of building the Shanghai Free Trade Zone and negotiating relatively ambitious bilateral investment treaties respectively with the United States and the EU. The government is now pushing through a new round of administrative regime reform, aimed at changing its role and further opening up China to the world.

Competition policy is another example showing the delicate link between the TPP and China’s reform agenda. TPP advocates “competition neutrality,” asking the host country to restrain its own SOEs, reducing market distortions due to the privileges of SOEs, and leveling the playing field. For many years, Chinese SOEs have been seen as “first among equals” in China’s corporate world. It is predictably a challenge for China to reform its own SOE sector.

To summarize, TPP does potentially have trade diversion effects on China, as well as competition pressure on China for further adjustment, coinciding with its new reform and opening-up agenda. However, the interesting linkage between TPP’s inductive role and China’s reform needs will not be automatically translated into reform achievements. The domestic resistance, which Chinese reformers now face, is much stronger than in the early 1990s.

## THE IMPLICATIONS OF TTIP FOR CHINA

There are two types of implications of TTIP for China: 1) “trade diversion effects,” which are mainly focused on the diversion of trade in goods; and 2) effects on rules.

**Trade Diversion** effects refer to trade that occurs between members of an FTA that replaces what would have been imports from a country outside the FTA. In other words, if the United States and the EU establish an FTA, China’s exports would decline owing to being crowded out by the increase of the EU’s exports to the U.S. market or of U.S. exports to the EU. Specifically, we use ESI (Export Similarity Index) to calculate the competing relationship between Chinese and European exports, as well as between Chinese and American exports. The ESI range is between 0 and 100. The higher the ESI, the more competitive the relationship is between Chinese and European or American exports. Using an ESI index based on the 2012 HS2 data of the U.S. International Trade Commission (USITC) and the Eurostat, we found that the similarity index of Chinese and European exports in the U.S. market is 45, while the similarity index of Chinese and American exports in the EU market is 46.4. This result shows that Chinese exports are competing with European and American exports to some extent. We also predict that, as Chinese products continue to climb the ladder of the value chain, the similarities between Chinese products and American and European ones would continue to increase, subsequently leading to more competition.

To further analyze the potential “trade diversion effects,” we looked into the top 20 categories of Chinese exports to the United States and the EU by comparing them with the top 20 categories of European exports to the United States and U.S. exports to the EU, giving us a deeper knowledge of the similarities. We found that in the U.S. market in 2012, 10 categories of Chinese and European exports are the same (Chs 85, 84, 94, 39, 73, 87, 90, 29, 40, and 71 of the two-digit Harmonized System tariff code or HS 2), arranged in descending order.<sup>3</sup> The Top 20 categories represented 89.8 percent of Chinese exports to the United States, and 88.1 percent of European exports to the United States.<sup>4</sup> Equally, in the European market, we found that nine categories of Chinese and American exports are the same (Chs. 85, 84, 39, 73, 29, 90, 87, 40, and 71 in order). The Top 20 categories represent 87.3 percent of Chinese exports to the EU and 88.2 percent of U.S. exports to the EU.<sup>5</sup> The more detailed findings are summarized in Table 1.

For the competing categories of Chinese, European, and U.S. exports, there are potential trade diversions, but the effects vary depending on the current tariff level. If the level is very low, the trade diversion would be marginal even after trade in goods were fully liberalized. If the tariff level is high, the trade diversion would be higher. Specifically, in the U.S. market, the tariff level for Ch. 40 (rubbers and articles thereof) is high. Chinese exports would face significant trade diversion once the tariffs were removed for European exports of that chapter to the U.S. market. We estimate that the affected value would be around \$5 billion. The tariff level for Chs. 87 (vehicles other than railway or tramway rolling stock), 90 (optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments, and accessories) 29 (organic chemicals) and 39 (plastics and articles thereof) is between 2 percent and 4 percent, we would then reason that the trade diversion would be considerable, affecting around \$39 billion worth of Chinese exports. The tariff level for Chs. 84 (nuclear reactors, boilers, machinery and mechanical appliances, computers), 85

**Table 1. Comparison Among Chinese, U.S. and European Exports in 2012**

Export Share (to China)				Import Share (from China)			
HS2	China	HS2	EU	HS2	China	HS2	U.S.
85	113,322	84	65,783	85	76556	84	38368
84	102,164	87	45,449	84	61964	27	19719
94	24,786	30	38,889	62	14738	30	19166
95	23,104	27	25,603	61	12495	90	19085
64	17,876	90	25,599	94	12260	88	15548
61	15,552	29	24,094	95	11386	85	14075
62	15,299	85	22,752	64	7788	29	10551
39	13,158	98	16,233	39	6619	71	9737
73	10,120	22	11,727	73	6528	87	8561
87	10,003	88	10,503	29	6396	39	5673
90	9,043	71	8,029	90	6328	38	4361
42	8,890	73	7,188	42	6081	97	2284
63	6,761	39	6,796	87	4698	99	1922
29	6,668	97	6,385	63	3104	73	1806
40	5,028	72	6,038	89	2953	33	1735
83	4,088	33	5,513	40	2859	40	1734
71	3,725	28	4,531	72	2637	8	1604
44	3,493	38	4,261	83	2596	26	1523
82	3,241	40	3,804	82	2344	28	1518
48	2,787	94	3,550	71	2292	48	1328

*Data Sources: USITC, Eurostat<sup>6</sup>*

(electrical machinery, equipment and parts, telecommunications equipment, sound recorders, television recorders), 71 (pearls, stones, prec. stones, precious metals, imitation jewelry, coins), 73 (articles of iron or steel), and 94 (furniture, bedding, cushions, lamps and lighting fittings, Nesol, illuminated signs, nameplates and the like, prefabricated buildings) is less than 2 percent. Therefore, using the data in Table 1, we conclude that the trade diversion effects would be marginal even though those chapters represent exports to the United States worth more than \$250 billion.

In the EU market, the tariff level for Chs. 29 (see above), 87 (see above), 39 (see above) and 40 (rubbers and articles thereof) are high (more than 4 percent). Chinese exports would face significant trade diversion once the tariffs were removed for U.S. exports to the EU market under those chapters. We estimate that the affected value would be around 20.6 billion Euros. Since the tariff level for Chs. 84 (see above), 90 (see above) and 85 (see above) is between 2 percent and 4 percent, we believe that the trade diversion would

be considerable, involving 145 billion Euros worth of exports to the EU. For Chs. 71 (see above), 73 (see above) and 94 (see above) the tariff level is low—less than 2 percent—therefore trade diversion effects of Chinese exports to the EU would be only marginal, affecting only 9 billion Euros, as calculated using the data in Table 1. Generally speaking, TTIP-induced trade diversion effects on China would be more significant in the EU market than in the U.S. market, largely because the EU market has, on average, higher levels of tariffs than the U.S. market.

Table 2. Implications of TTIP for Chinese Exports						
Import Tariff Rate	U.S. Market			EU Market		
	HS2 Chapters	Value of Chinese Exports Affected by TTIP (billion US\$)	Impact Level	HS2 Chapters	Value of Chinese Exports Affected by TTIP (billion Euro)	Impact Level
>4%	40	5.028	Significant	29, 87, 39, 40	20.572	Significant
2%-4%	87, 90, 29, 39	38.872	Considerable	84, 90, 85	144.848	Considerable
<2%	84, 85, 71, 73, 94	254.117	Marginal	71, 73	8.820	Marginal

*Data Sources: World Tariff Profiles 2012, WTO; USITC<sup>7</sup>*

In addition to creating the above “trade diversion effects,” TTIP would also have trade creation effects, which could benefit China. A study done by the Centre for Economic Policy Research suggests, however,<sup>8</sup> that these effects could do no more than help China to increase exports by 0.5 percent and its GDP by 4 to 5 billion Euros, equivalent to 0.02-0.03 percent of its GDP. As Table 2 shows, the value of Chinese exports considerably affected by TTIP trade diversion effects would be 199.6 billion Euros. Even if the actual trade diversion were only 10 percent, the total value would be as high as around 20 billion Euros, roughly 1 percent of total exports and 0.3 percent of China’s GDP. Therefore, we believe that the cost imposed by TTIP trade diversion on China is much larger than the potential benefits of TTIP’s trade creation.

**Rules Effects** might also worry the Chinese government, more specifically, who controls the rule-setting power. For decades, China has been pursuing a new international economic order together with other developing countries. There is a strong groundswell within China to say farewell to the old days when others set the rules. Through TTIP, the United States and EU,

as suggested by both parties, will develop a new generation of global trading rules concerning state-owned enterprises, subsidies, intellectual property rights, public procurement, raw materials, and environmental and labor standards—all areas for which China is most criticized for not obeying global trading rules. Once the transatlantic community sets new rules, Chinese exports would face new difficulties. Equally, China will find it more difficult to negotiate new trade deals with the United States and EU. These factors might lead to new flashpoints of trade tensions. Here, we offer two examples of the potential rules effects resulting from the conclusion of the TTIP: government procurement and state-owned enterprises.

### **Government Procurement**

As the initial EU position paper on government procurement states, “this negotiation (TTIP) would present an important opportunity for the EU and the U.S. to develop together some useful ‘GPA plus’ elements to complement the revised GPA disciplines... A model text agreed between the EU and the U.S., being the two largest trading partners in the world, could thus possibly set a higher standard that could inspire a future GPA revision.”<sup>9</sup> China committed itself to joining the Government Procurement Agreement when joining the WTO, and in 2007 started the accession negotiations. Due to differences in the level of ambition, China’s several offers have fallen short of the expectations of GPA contracting parties. The high ambitions set by the EU and the United States in their TTIP negotiations would make China’s accession to the GPA an even more daunting task.

### **State-Owned Enterprises**

In the TTIP negotiations, the United States seeks to establish appropriate, globally relevant disciplines on state trading enterprises, SOEs, and designated monopolies, such as disciplines that promote transparency and reduce trade distortions.<sup>10</sup> Similarly, the objective of the EU is to create an ambitious and comprehensive global standard to discipline state involvement and influence in private and public enterprises, building and expanding on the existing WTO rules. The EU believes that could pave the way for other bilateral agreements to follow a similar approach and eventually contribute to future multilateral engagement.<sup>11</sup> China is well known for the significant role played by the SOEs in its economy. China’s model of economic growth is even described as “state capitalism” (as opposed to free market capitalism).<sup>12</sup> It is foreseeable that China in the one camp and the EU and the United States in the other might compete fiercely for world market shares based on their own economic growth model, and against that background, the debate on the SOEs rules would be of even greater significance.

## **THE IMPLICATIONS OF THE EU-JAPAN FTA FOR CHINA**

The completion of the EU-Japan FTA would give the EU much better access to the Japanese market, and vice versa, both of which mean disadvantages for China’s market access to those two markets. As Table 3 shows, the percentage of zero tariff imports of Japan from China is 70.3 percent and from the EU is 48.7 percent. Once the EU-Japan FTA is completed, the categories of European exports to Japan subject to zero tariff treatment will increase significantly, exerting a huge impact on Chinese exports to Japan. Another look at the



treatment of Chinese and Japanese exports in the EU market shows that 49.6 percent of the total value of Chinese exports are free of duties while the figure for Japan is 44.0 percent. With the completion of the EU-Japan FTA, a significant increase in the value of Japanese exports subject to zero tariff treatment will be realized. Again, Chinese exports to the EU will be put at a disadvantage.

**Table 3. Non-Agricultural Import Tariffs of Japan and the EU in 2010**

	Arithmetically average	Weighted average	Percentage of zero tariff imports (categories)	Percentage of zero tariff imports (value)
<b>JAPANESE IMPORTS OF NON-AGRICULTURAL PRODUCTS FROM:</b>				
<b>China</b>	3.8	2.6	70.3	77
<b>EU</b>	3.7	1.6	48.7	72.8
<b>EU IMPORTS OF NON-AGRICULTURAL PRODUCTS FROM:</b>				
<b>China</b>	4.4	3.3	24.9	49.6
<b>Japan</b>	4.4	3.0	23.0	44.0

*Data source: World Tariff Profiles 2012, WTO, pp. 66-97<sup>13</sup>*

Using an ESI index based on the 2011 HS2 data of Eurostat and Statistics Japan (Statistics Bureau of Japanese Ministry of Internal Affairs and Communications), we found that the similarity index of Chinese and European exports in the Japanese market is 66, while the similarity index of Chinese and Japanese exports in the EU market is 58. This shows that Chinese exports are competing with European and Japanese exports respectively in the Japanese and European markets to a great extent. As Chinese products continue to climb the value chain, the similarities would continue to increase, leading to more competition.

To further analyze potential trade diversion effects, we looked into the top 20 categories of Chinese exports to the EU and Japan by comparing them with the top 20 categories of Japanese exports to the EU and of EU exports to Japan. We thereby gained more insight into the similarities of Chinese products and Japanese and European ones. We found that in the Japanese market in 2011, eight categories of Chinese and European exports represent 69.8 percent of Chinese exports to Japan and 86.4 percent of European exports to Japan. Equally, in the European market, we found that 13 categories of Chinese and Japanese exports, respectively Chs 85, 84, 95, 73, 39, 29, 90, 87, 89, 72, 40, 71 and 82, represent 87.0 percent of Chinese exports to the EU and 94.1 percent of Japanese exports to the EU.

For competing categories of Chinese, European, and Japanese exports, there are potential trade diversions, but the diversion effects vary depending on the current tariff level. Again, if it were very low, the trade diversion would be marginal even after trade in goods is fully liberalized. If it were high, the trade diversion would be higher. Specifically, in the

**Table 4. The Top 8 Categories of Chinese and European Exports to Japan in 2011**

Japanese Market (Unit: million JPY)		
Categories	China	EU
Food	747,060	780,661
Raw Materials	183,140	212,978
Fossil Fuels	146,826	42,649
Chemical Products	1,059,309	2,028,857
Industrial Manufactured Products	1,807,126	478,143
Non-electrical Machinery	2,366,682	681,312
Electrical Machinery	3,635,148	547,548
Transport Equipment	277,630	768,974
Others	4,419,026	860,886

Data source: Bureau of Japanese Ministry of Internal Affairs and Communications<sup>14</sup>

**Table 5. Top 20 Categories of Chinese and Japanese Exports to the EU in 2011**

EU Market (Unit: Million Euros)			
HS2	China	HS2	Japan
85	79,809	84	18,637
84	58,056	85	13,087
62	16,381	87	12,344
61	13,671	90	5,749
95	12,643	29	2,375
94	11,507	71	2,372
64	7,583	39	1,823
73	6,584	40	1,723
39	6,170	38	1,048
29	5,943	73	1,035
42	5,853	30	1,005
90	5,662	32	714
87	4,576	37	570
89	4,217	95	479
72	3,791	82	450
63	3,127	72	443
40	2,988	89	365
83	2,432	28	327
71	2,321	96	325
82	2,208	99	297

Data source: European Commission, Eurostat<sup>15</sup>

Japanese market, the tariff level for food and fossil fuels is relatively high. We would assume that trade diversion would be significant, affecting around 894 billion Yen (JPY) (around \$9 billion) worth of Chinese exports. The tariff level for chemical products is moderate, affecting 1.0593 trillion JPY (\$10.7 billion) worth of Chinese exports. The levels for raw materials, non-electrical machinery, electrical machinery, transport equipment, and industrial manufactured products are low. We assume marginal trade diversion effects, even though total Chinese exports of those categories would be 8.270 trillion JPY (\$83.4 billion).

In the EU market, the tariff levels for Chs. 29 (see above), 87 (see above), 89 (ships, boats, and floating structures), 39 (see above), and 40 (see above) are high—more than 4 percent. Chinese exports would face significant trade diversion once the tariffs were removed for Japanese exports to the EU market under those chapters. We estimate that the affected value would be around 23.896 billion Euros. Since the tariff level for Chs. 82 (tools, implements, cutlery, spoons and forks of base metal, parts thereof of base metal), 84 (see above), 90 (see above) and 85 (see above) and 95 (toys, games and sports requisites, parts and accessories thereof) is between 2 percent and 4 percent, we believe that the trade diversion for those chapters would be considerable, involving 158.379 billion Euros worth of Chinese exports to the EU. For Chs. 71 (see above), and 73 (see above), the tariff level is low—less than 2 percent; therefore the trade diversion effect of exports to the EU would be only marginal, affecting 12.696 billion Euros.

In general, the trade diversion effects on China would be roughly the same in the EU market and the Japanese market, because both markets have, on average, a sizable tariff rate compared to the U.S. market. As Table 6 suggests, the values of Chinese exports significantly affected by the EU-Japan FTA trade diversion effects would be \$258.7 billion (around 200 billion Euros). Even if the actual trade diversion were only 10 percent, the total value would be as high as 20 billion Euros, roughly 1 percent of China's total exports and 0.3 percent of China's GDP.

## CHINA'S RESPONSE SO FAR

Given the above contexts, Chinese policy-makers are faced with three broad questions: Multilateralism or bilateralism? Competing bilateralism or harmonious bilateralism? Further reform or turning inward?

### Multilateralism or Bilateralism?

China is accelerating implementation of its FTA strategy. It recently concluded an FTA with Switzerland, the first major economy in Europe with which China signed a FTA. China has made clear that FTA priority is given to a China-Japan-Korea FTA, a China-Australia FTA, and China's FTA with the western Asia region.<sup>16</sup> It seems that China is giving priority to bilateralism; however, the official rhetoric does not indicate this. One of its chief trade negotiators announced that China would adhere to the position that multilateralism is the main avenue of trade while regional (bilateral) trade arrangements are complementary.<sup>17</sup> As China's former WTO ambassador Sun Zhenyu predicted, "Multilateralism is the ultimate direction." He commented that "Now is a special period," and that "The pendulum of trade liberalization might swing back to multilateralism at the end of the day." He also

**Table 6. Implications of EU-Japan FTA for Chinese Exports**

Import Tariff Rate	Japanese Market			EU Market		
	Product categories	Value of Chinese Exports Affected (billion US\$)	Impact Level	HS2 Chapters	Value of Chinese Exports Affected (million Euro)	Impact Level
>4%	Food, fossil fuel	9	Significant	29, 87, 89, 39, 40	23,896	Significant
2%-4%	Chemicals	10.7	Considerable	82, 84, 90,85, 95	158,379	Considerable
<2%	Raw materials, non-electrical machinery, electrical machinery, transport equipment and industrial manufactured products	83.4	Marginal	71, 72, 73	12,696	Marginal

*Data source: World Tariff Profiles 2012, WTO, and Bureau of Japanese Ministry of Internal Affairs and Communications, compiled by authors*

suggested that “The regional trade arrangements that we are now discussing might be multilateralized and it is necessary to agree on a set of multilateral rules for governing various regional arrangements.”<sup>18</sup> For many Chinese trade veterans, it is impossible to give up the WTO as China is one of the biggest beneficiaries of the WTO. They fought so hard to make China join the WTO, and it is unthinkable to turn away from it.

Then, how can we explain the gap between China's official rhetoric and actual deeds? There are at least two explanations. One is that China is responding to competing pressure resulting from the FTA adventures of western powers, including Europe, the United States, and Japan. Given the potential trade diversion effects and loss of rule-setting power, China has to accelerate its own FTA efforts as a precautionary move. The second explanation is that China is using the FTA as a geostrategic tool to consolidate its influence in the Asia-Pacific region, as it is now negotiating FTAs respectively with Japan and Korea, Australia, and the Gulf Cooperation Council. With those factors in mind, China will probably continue to build its trade policy on two pillars—multilateralism and bilateralism. Priority might be given to bilateralism as the Doha Round is stuck. That being said, China prefers not to leave the world with the impression that China has given up on the Doha Round.

## Competing Bilateralism or Harmonious Bilateralism?

Will the FTA initiatives by the United States, Japan, Korea, ASEAN, and other regional players create tensions in trade relations with China? This question is particularly relevant in the context of increasing U.S.-China strategic competition and China's territorial disputes with Japan, the Philippines, Vietnam, and others. China is also deeply worried about the economic implications of the TPP, TTIP, EU-Japan, and other regional economic initiatives excluding China. Those implications range from trade diversion effects to setting up new rules without China's participation.

Generally speaking, China is concerned with the latest trends of heightened bilateralism and regionalism in the Asia-Pacific region, which is no longer harmonious, but is generating considerable tension. China's ideal of a "harmonious world" is colliding with the cold fact of "competing bilateralism." Against that background, China's possible responses might be pragmatism in action combined with idealist rhetoric. A lack of multilateral governance of world trade may lead to more bilateral trade tensions between China and its western trading partners. China is now pushing through three overlapping regional initiatives of economic integration— China-Korea FTA, China-Japan-Korea FTA, and RCEP. It remains unclear which among the three is given top priority. All three may be affected by prominent hindrances, including territorial disputes.

## Further Reform or Turning Inward?

TPP, TTIP, Japan's FTA with the EU, together with FTAs launched by other western economies are creating external pressure on China's domestic reform and opening-up. The timing is opportune, considering the arrival of a new generation of more reform-oriented top leaders. A good example is the fact that Li Keqiang took credit for launching the China-Switzerland FTA when he was vice premier and concluding that FTA during his first trip in Europe in May 2013 after assuming the premiership.

It seems increasingly obvious that the new leadership is cleverly using external pressure for pushing forward domestic reform. During his meeting with Obama, Xi Jinping announced that China was studying pushing through a mid- and long-term comprehensive reform program,<sup>19</sup> which was finally announced during the third plenary session of the 18<sup>th</sup> Congress. Li's patronage of China's FTA with Switzerland might open a new era for FTA negotiations with developed economies, including Australia first and then the EU second. Li's predecessor premier Wen Jiabao had already proposed a FTA feasibility study with the EU last year. The conclusion of the trilateral China-Japan-Korea is also at the top of China's FTA strategy list. All these FTAs are potential drivers for China's domestic reform.

## Predicting China's Future Actions

China will definitely seek to play a larger role in the Asia-Pacific region, where it has the most fundamental and essential interests. Regional economic initiatives will be dealt with by the government from both strategic/political and economic perspectives. Both considerations will be present when China negotiates regional and bilateral FTAs. The question is which consideration prevails, the strategic and political or economic.

Faced with the options of RCEP, the China-Korea-Japan FTA, or TPP, China currently would rank order its preferences as China-Korea FTA, RCEP, and finally TPP. The China-Japan-Korea FTA used to be a priority, but given the territorial disputes between China and Japan and between Korea and Japan, the CJK FTA could not be advanced in a significant way in the near future. The bigger question now facing China is whether to join the camp led by the United States, the EU, and Japan, or to establish its own camp of regional economic integration. China obviously prefers the latter, but whether it could succeed in a China-Korea-Japan FTA and RCEP remains uncertain. The variables include China's capacity, political will, and interactions with other negotiating parties, in particular Japan and the United States in the background. It is equally fundamental whether the Chinese government could garner sufficient domestic support for pushing through big FTAs and whether China's reformers could establish a linkage between external pressure induced by the above-mentioned mega-FTAs and China's own domestic reform agenda.

China is bound to lead in Asian economic integration, considering the fact that it is already the world's biggest trading nation (in goods) and the second largest economy. But it has a lot of constraints, both internal and external. They restrict its capacity to convert its economic strengths into regional influence. A new development worthy of future investigation is China's new initiatives for building two grand silk roads, one to Central Asia leading to Europe, and the other with Southeast Asian countries leading to the Indian Ocean. They represent both a new and old type of regional economic integration: "old" in the sense that China's way of Asian economic integration is still traditional since it relies on aid and credit in helping countries to build infrastructure and promote trade with China; "new" in the sense that China is finding the confidence to rediscover its role in Asia.

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# ASIA'S SLIPPERY SLOPE: TRIANGULAR TENSIONS, IDENTITY GAPS, CONFLICTING REGIONALISM, AND DIPLOMATIC IMPASSE TOWARD NORTH KOREA

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